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COMMODITY FUTURES TRADING

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I. Operation of Futures Markets Under the Commodity Exchange Act

A. *Introduction*

Commodity futures markets play an integral part in our marketing system by permitting producers, processors, and merchandisers of commodities to hedge the prices at which they buy or sell on a particular day. For example, when a local elevator operator buys grain from a farmer, the operator may sell the same quantity on the futures market deliverable at about the same time he anticipates selling the cash grain he has purchased. When the actual sale is made, he "lifts" his hedge by buying the same quantity on the futures market in the same futures month he previously sold in. If the price of grain on the cash market fluctuates either up or down, the gain or loss should be approximately offset by the hedged position.

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The use of the futures market as a price protection device by the elevator operator or any other individual who is engaged in the buying, selling or processing of commodities, is dependent upon the premise that the futures market will move in the same direction as the cash market. Thus, it is assumed (an assumption which is justified by historical pricing patterns) that if the price of the cash commodity which is in actual existence and which is being bought and sold, increases between now and a date certain in the future, the price of the same commodity in a futures contract calling for delivery at the same date certain in the future, will increase correspondingly.

When a farmer brings his crop to the local country elevator, the elevator operator will probably determine the price he will pay, on the basis of the "backed off" current price for that commodity at the nearest large terminal market, for example, Chicago. The "backed off" price is the price at the terminal market reduced by estimated costs and margins he considers adequate to complete delivery to that market if no better market can be found. If, based upon the current terminal market price, the operator purchases the grain and takes possession with the intention of reselling and delivering 6 months later, he would be assuming the risk of a price decrease between the date he buys from the farmer and the date he actually resells. He can protect himself by utilizing the futures market to sell a corresponding amount for delivery at the same time he expects to resell the cash grain he has purchased from the farmer.

Thus, in this situation if the market price of the cash commodity drops 15 cents per bushel between the time the elevator operator purchases the grain and the time he resells it 6 months later, he would incur a loss of $1,500 on each 10,000 bushels. If, however, at the time he purchased the grain from the farmer he had sold the same amount of grain on the futures market in a contract which matured 6 months later, the futures price should also decrease a similar 15 cents per bushel and the elevator operator would profit $1,500 on each 10,000 bushels he sold on the futures market. The net effect, of course, of these offsetting purchases and sales would be to guard the elevator operator against loss, thereby permitting him to continue in business without regard to price fluctuation, providing the futures market operates in the normal historical manner.

Such use of the futures market by a producer, buyer, or seller of the commodity takes the gamble of commodity price fluctuation out of his operation and enables him to lock in a relatively small margin of profit. This system has worked well most of the time, but whenever the supplies of commodities are short or the number of speculators becomes excessive, opportunities exist for manipulations and distortions in the marketing system to such a great extent that the market no longer can accurately reflect real supply and demand, and during part of the marketing season, prices can either be artificially raised or lowered.

During the early 1970's fluctuations in the market were so wide and erratic as to indicate the possibility of price manipulation and squeezing. Businessmen who handled commodities on some occasions were unable to buy back contracts the day they sold the commodity and many of them found that the commodities markets, such as the Chicago Board of Trade and the Chicago Mercantile Exchange, did not always provide a dependable place to hedge their business deals. With the compromising of this kind of price insurance, many businessmen who handled commodities felt compelled to substantially increase the amount they charged for their part in the marketing system and even then some lost vast sums of money. As a result, many of them tripled or quadrupled the normal margin to cover new risks or decided to act only on a commission basis.

Consumers are also greatly affected by any breakdown in our marketing system. When the futures markets are manipulated or become undependable, wider margins required at each level add to the price of the final product. Historically, erratic swings in prices result in retail prices going up more than they later come back down. It is thus apparent that consumers also have a great stake in preventing excessive speculation or manipulation from causing wide fluctuations in commodity prices.

In 1972 and 1973 there were numerous strong indications that widespread speculation in commodities had created substantial problems and contributed to:

(1) Wide fluctuations in poultry and meat production costs;

(2) an increase in the spread between the amount the producer receives and the price the consumers pay;

(3) a "squeezing" of producers and processors of food, feed grains and other commodities who need to use the market to "hedge"; and,

(4) a denial to many processors and retailers of their usual access to supply.

A small business subcommittee which I was privileged to chair then began an investigation to examine the effectiveness of the Commodity Exchange Authority, an agency of the Department of Agriculture, in its regulation of this country's boards of trade and other commodity exchanges. It was the intent of the subcommittee to ascertain whether futures trading was conforming to the purposes of existing law and whether the Federal agencies were adequately and effectively protecting the interests of the general public who trade in commodity futures. (Trading in regulated commodities in fiscal year 1973 totaled some $268 billion and involved approximately 18 million transactions and this volume measured in dollars has almost doubled in the past two years. Additionally, trading in nonregulated commodities totaled some $131 billion and involved approximately 6 million transactions.) In view of the amount of increased value in futures being traded, the subcommittee believed that it was imperative to determine whether such a substantial portion of our economy should be left largely to self-regulation by the boards of trade and the commodity exchanges.

B. Commodity Marketing

There probably has been no industry in the United States which has grown faster in the past few years than has our commodity marketing system. The volume of grain produced has doubled and quadrupled in many cases. In addition, a larger percentage of the grain is moving interstate and over international transportation systems rather than moving merely from one farm to an adjoining farm.

As late as 20 years ago, there were relatively few large cash grain producers and most of their product was sold for cash after the crop was harvested and it was determined how much would not be needed for livestock feeding. The relatively small amounts that were shipped by rail to some other market were usually in turn sold for cash or hedged by such a large number of small merchandisers that there was really little opportunity for manipulation of the market in most years.

Today 25 percent of all the corn raised is shipped overseas, more than 50 percent of all soybeans are exported and in the 1975 marketing year only 600 million bushels of wheat out of a supply of 2.1 billion bushels will be used domestically. No longer do our grain marketing facilities consist only of several thousand local elevators; they now also include a very few huge international grain marketing companies of which only two are publicly held United States corporations, the others being private companies and/or foreign owned.

Our marketing system has been, on an overall basis, a very good thing for producers, processors, consumers, and the Nation. In fact, historically the system has operated so well that people within the system itself could not believe how vulnerable it is to manipulation and abuses. One of the reasons that the vulnerability is not apparent is that except for the last several years there has always been a surplus of most commodities and also an abundance of transportation to shift those commodities around so that if need be a commodity could be delivered in lieu of buying back a futures contract. This situation has now changed. We do not have a surplus every year nor do we have an insulated reserve which could be used to reduce the height of the peaks and the depth of the valleys.

1. *Speculator Involvement in Hedging*

Futures trading involves the purchase and sale of contracts for delivery at some future date of certain quantities of specified commodities at fixed prices. It evolved from a system of trading in time contracts for commodities under the terms of which a seller was obligated to deliver a designated quantity of a specific commodity within a specific period, varying from about one day to one year, at an agreed-upon contract price. The buyer in such a time contract frequently sold the commitment to another trader, and such transfers at changing prices resulted in the present system of trading contracts for future delivery of commodities. The need for meeting places to conduct these activities resulted in the establishment of futures markets such as the Chicago Board of Trade and the Chicago Mercantile Exchange, the two major exchanges trading in regulated commodities.

Producers, merchants, and processors use the futures markets for nonspeculative trading known as "hedging." At the same time, however, others have been using the futures markets as a means of speculating on the rise and fall of prices. The trader who is speculating is, in effect, the individual who assumes the risk which the hedger seeks to avoid. To the extent that hedgers on both sides are short and long in equal quantities, some speculators are needed to make the market more stable and as such in the absence of abuses a speculator can perform an important economic function because his continuous trading is necessary to permit effective hedging.

2. *Regulation of Futures Markets*

The basic regulatory act, originally designated as the Grain Futures Act[1] was enacted on September 21, 1922, and authorized the Secretary of Agriculture to regulate futures trading in wheat, corn, oats, barley, rye, flax, and sorghums. This Act was strengthened by amendments in 1936[2] and was renamed the Commodity Exchange Act, the fundamental purpose of the Act being "to insure fair practice and honest dealing on the commodity exchanges and to provide a measure of control over those forms of speculative activity which too often demoralize the markets to the injury of producers and consumers and the exchanges themselves."[3] The 1936 amendments and the more recent 1968 amendments,[4] while adding new commodities, also modified and expanded certain provisions to strengthen Federal regulation.

The Commodity Exchange Act was predicated upon findings and conclusions of the Congress that (1) transactions in commodity futures are carried on in large volume by the public, as well as by persons engaged in the business of buying and selling agricultural commodities in interstate commerce, and (2) such transactions and prices are susceptible to speculation, manipulation, and control, and sudden and unreasonable price fluctuations, and such fluctuations are a burden upon interstate commerce and make regulation essential in the public interest.

In effect, the old Act required that futures trading in regulated commodities be conducted on a commodity exchange designated as a contract market by the Secretary of Agriculture. Futures trades (transactions) are made by or

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1. 7 U.S.C. § 1 (1970).
2. Act of June 15, 1936, ch. 545, 49 Stat. 1491, *amending* 7 U.S.C. §§ 1-17 (1922) (codified at 7 U.S.C. §§ 1-17 (1940)).
3. H.R. Rep. No. 421, 74th Cong. 1st Sess. (1938).
4. Act of July 23, 1968, Pub. L. No. 90-418, 82 Stat. 413, *amending* 7 U.S.C. § 2 (1964) (codified at 7 U.S.C. § 2 (1970)); Act of Feb. 19, 1968, Pub. L. No. 90-258, 82 Stat. 26, *amending* 7 U.S.C. §§ 2, 6-9, 12, 13, 15 (1964) (codified at 7 U.S.C. §§ 2, 6-9, 12, 13, 15 (1970)).

through a member of such commodity exchange, with a separate futures market being established for each regulated commodity traded on a contract market.

The Secretary of Agriculture established the Commodity Exchange Authority (CEA) as an agency in the Department of Agriculture to administer the Commodity Exchange Act. He delegated to the CEA his authority under the Act except his authority to designate contract markets, promulgate regulations, and issue complaints for violations of the Act. The Secretary served as Chairman of the Commodity Exchange Commission, the other members of the Commission being the Attorney General and the Secretary of Commerce. However, the Commission was a relatively inactive governmental body which met very seldom, and the statutorily designated member usually was represented on the Commission by his designate.

CEA's principal functions included (1) the supervision of futures trading and the investigation of suspected violations, (2) the audit and examination of the records of futures commission merchants (FCMs), (3) the compilation and publication of market data, and (4) the annual registration of about 250 FCMs and about 1,400 floor brokers.[5]

Under the Commodity Exchange Act, contract markets had the authority, with certain limitations, to admit members and select officers; discipline offenders and expel members; determine delivery months and contract terms; fix price fluctuation limits (the amount of permissible price change during a trading day); and establish margin requirements, brokerage fees, and commissions.

C. *Market Disruption (1972-73)*

Against the background of legislative regulation of futures markets, there occurred a series of events in the latter part of 1972 and the first part of 1973 which caused unusual upward fluctuation in the price of agricultural commodities traded on the futures markets. Such upward movement in price is shown in the following charts A through F which compare the fiscal year 1973 cash prices to the fiscal year 1972 cash prices of six selected commodities, soybeans, wheat, corn, live cattle, pork bellies, and shell eggs.

As is illustrated by the price movements charted, the economic law of supply and demand probably was applicable to the upward price movement of such commodities at the start of the period. The prospect of still further price increases attracted speculators to these markets and such increasing speculative pressures in turn were reflected in increasing prices and radical price movements, both up and down, at times when there were no discernible changes in supply and demand of the commodities, principally food and feed grains and their by-products.

5. 17 C.F.R. §§ 1.1 *et seq.* (1975).

CHART A

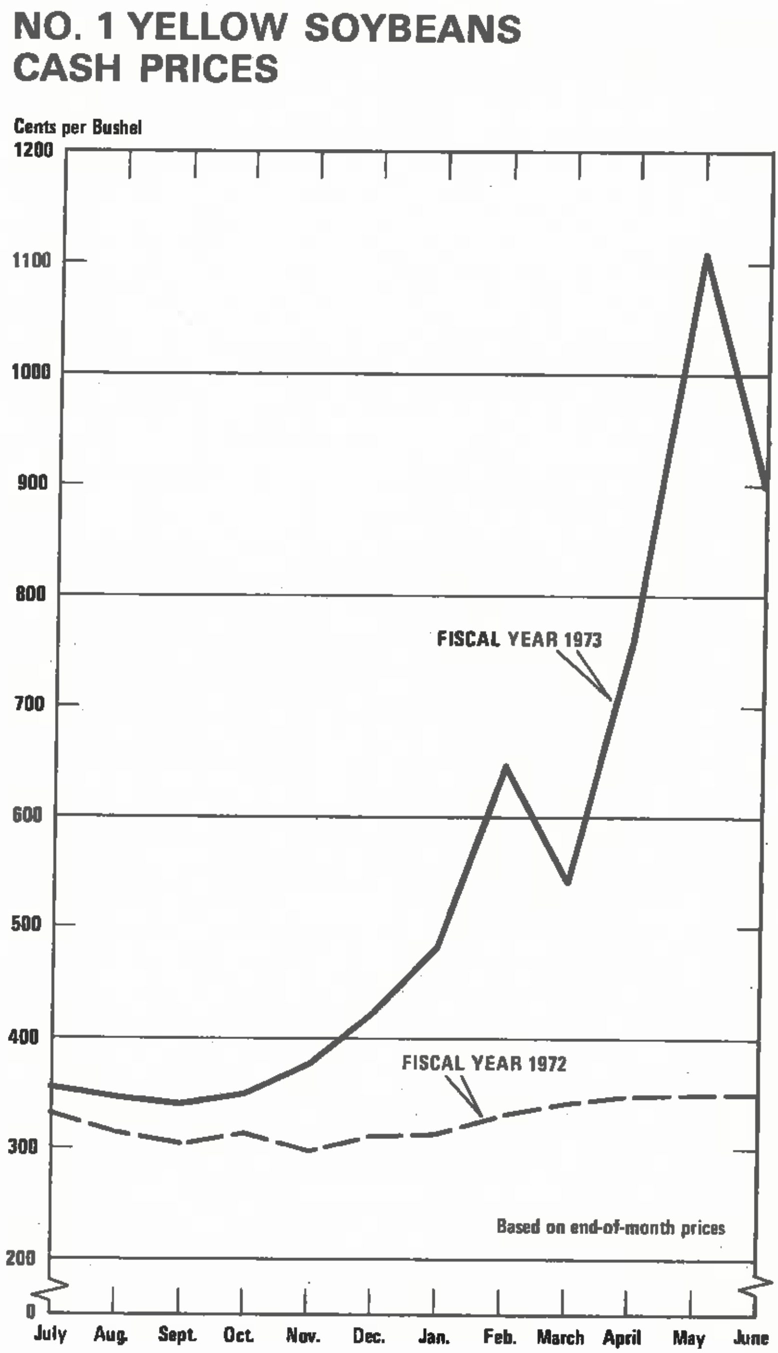

NO. 1 YELLOW SOYBEANS
CASH PRICES
Cents per Bushel
1200
1100
1000
900
800
700
600
500
400
300
200
0
FISCAL YEAR 1973
FISCAL YEAR 1972
Based on end-of-month prices
July
Aug.
Sept.
Oct.
Nov.
Dec.
Jan.
Feb.
March
April
May
June

CHART B

NO. 2 SOFT RED WHEAT CASH PRICES

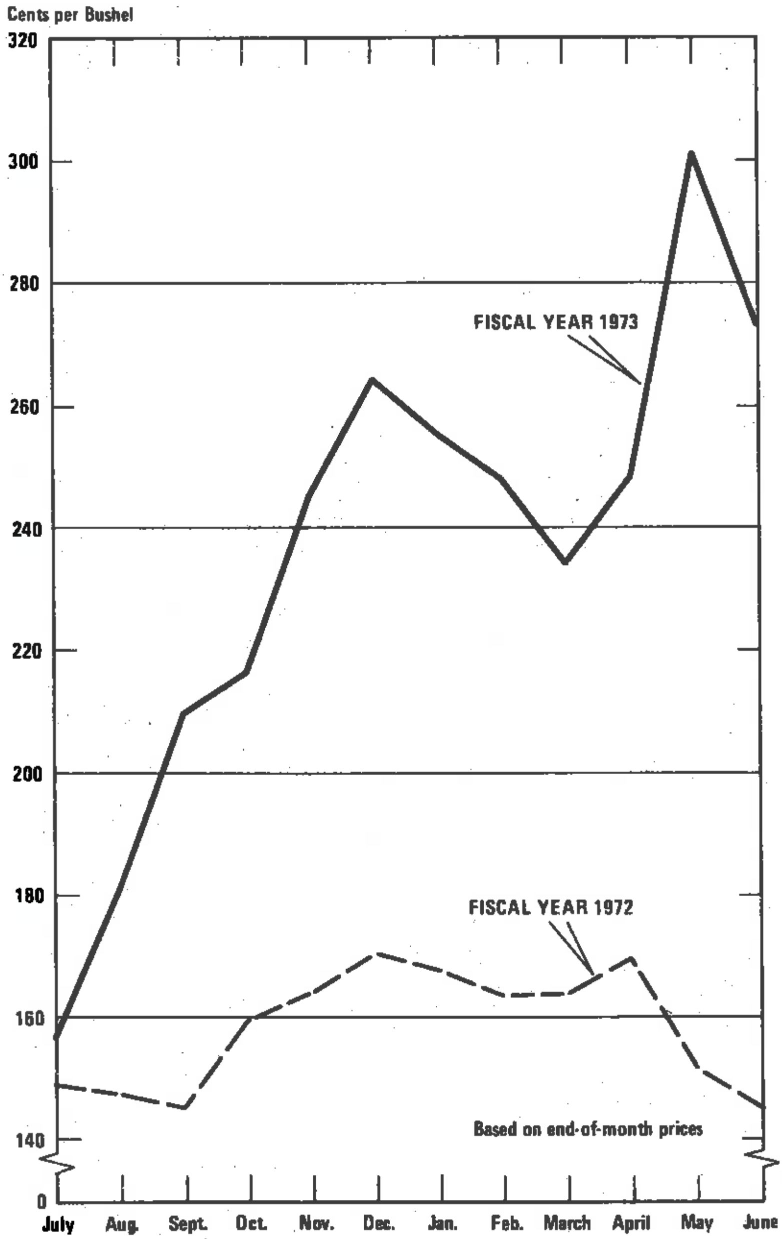


CHART C

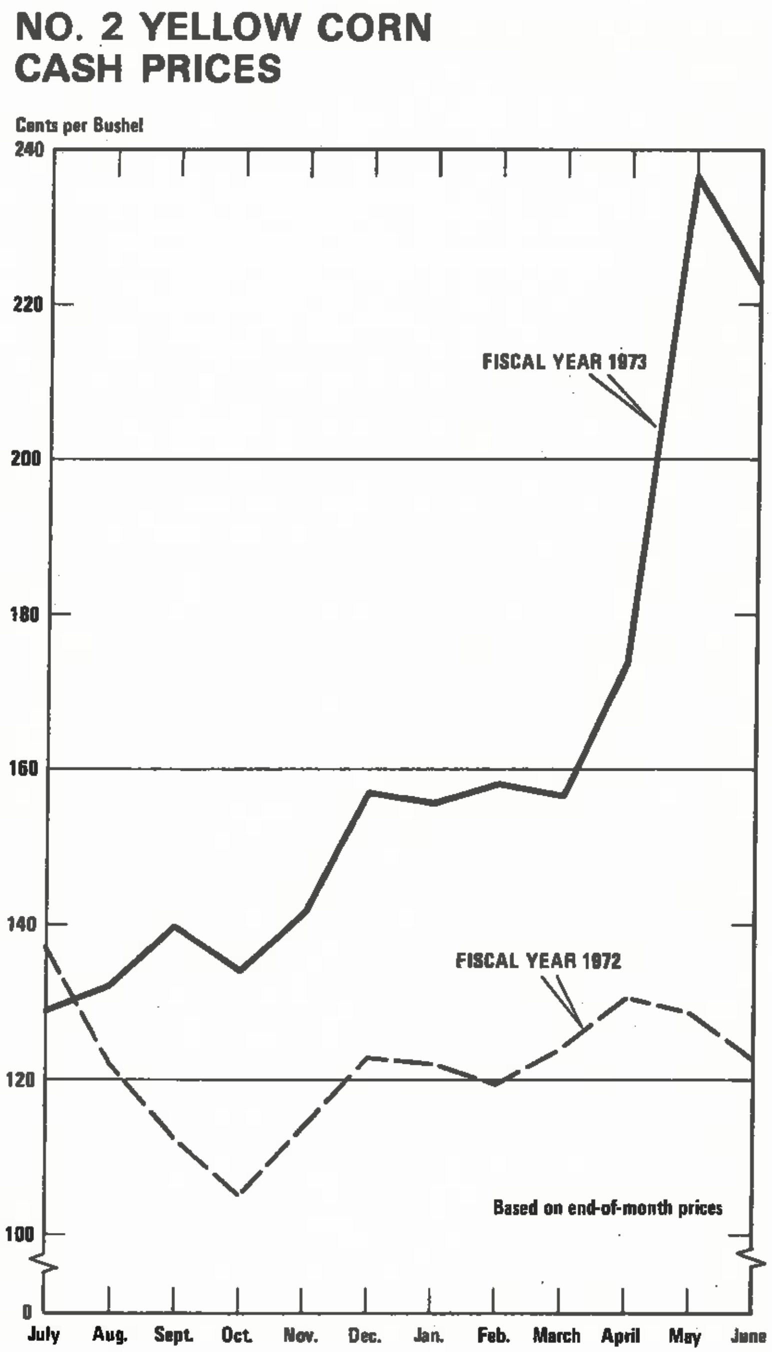

NO. 2 YELLOW CORN
CASH PRICES
Cents per Bushel
240
220
200
180
160
140
120
100
0
FISCAL YEAR 1973
FISCAL YEAR 1972
Based on end-of-month prices
July
Aug.
Sept.
Oct.
Nov.
Dec.
Jan.
Feb.
March
April
May
June

CHART D

1100-1300 POUNDS LIVE CATTLE CASH PRICES

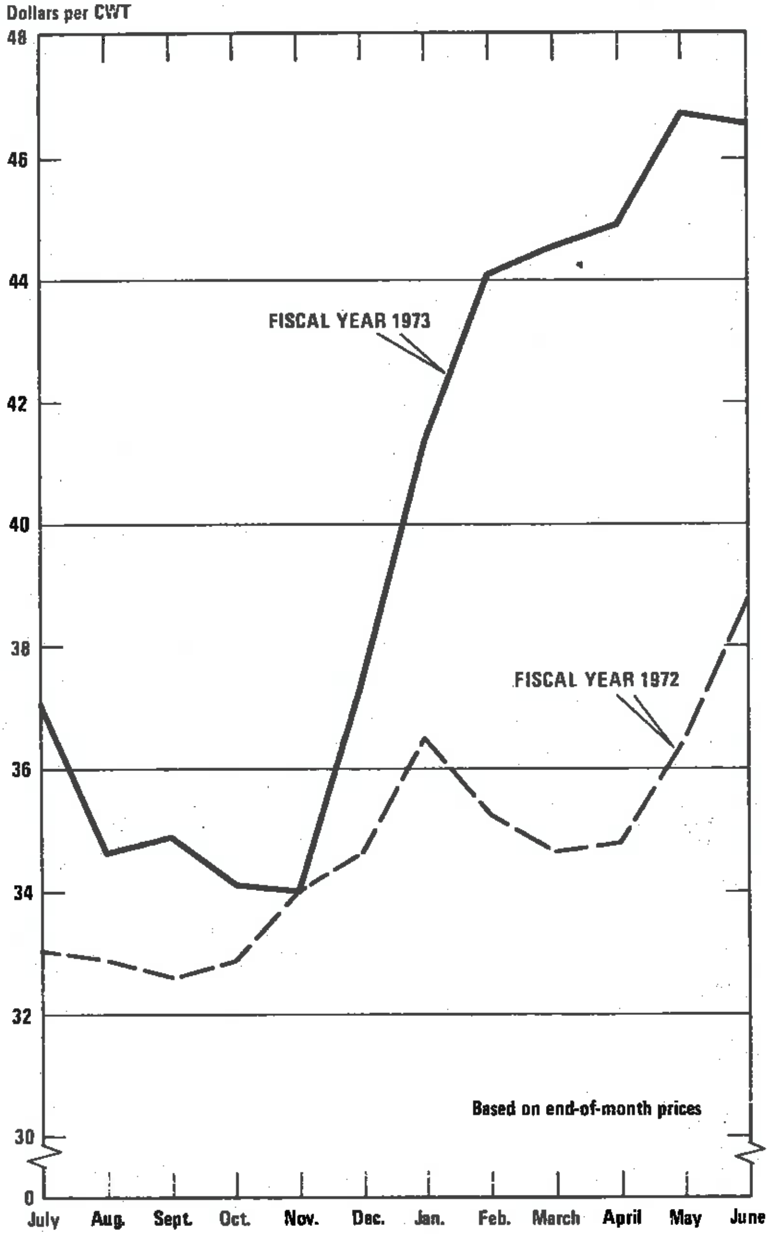
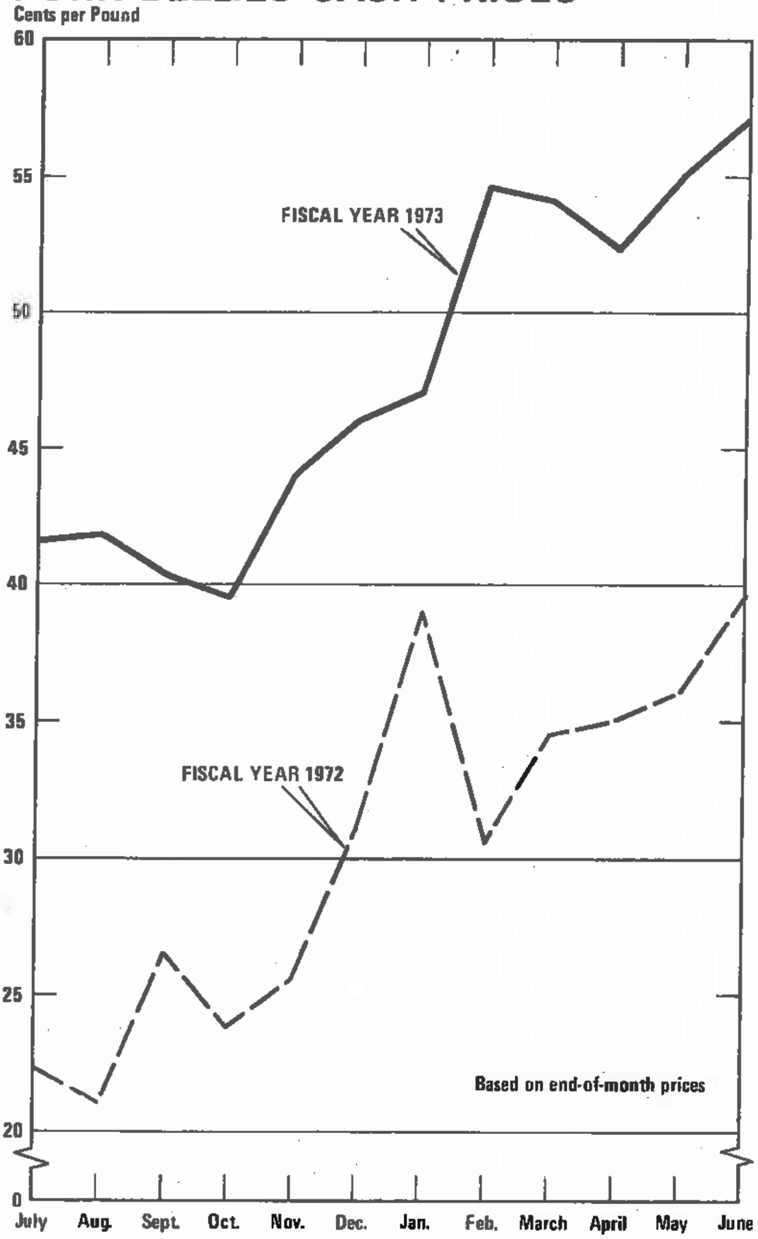


CHART E

FRESH OR FRESH FROZEN FREEZER ACCUMULATED 12-14 POUNDS PORK BELLIES CASH PRICES



occasioned by an exchange change in the amount of margin required as the Chicago Board of Trade did in 1973.

In the event there is a margin call, that is, if the customer's equity in his account is less than the amount required to maintain his position, he must make a cash deposit (or occasionally deposit securities as collateral) or his account will be closed, that is, the broker will offset his position by making a trade which is the opposite of the customer's market position. Thus, if the customer was previously long (had purchased) one contract of July soybeans (5,000 bushels), the broker would sell one contract of July soybeans, and the customer would have his market position eliminated; but, he would be liable for any loss due to adverse price movement prior to the sale and might owe his broker even more than the amount of his original deposit.

Using the actual price of July 1973 soybean futures on the Chicago Board of Trade, let us see what happened to a trader who sold 100,000 bushels, or 20 contracts, at a price of $6.93½ per bushel on May 1, beginning with a deposit of $50,000 to his account. At the end of each day, the gain or loss from the change in price of July soybean contracts would be posted to his account as "equity." Should the equity in his account fall to the amount of "maintenance margin", he must deposit a sufficient amount to bring the account back up to the initial margin.

On May 2, as on most of the days during the life of the July soybean future, the price increased 15 cents per bushel and the trader incurred a loss of $15,000, leaving the equity in his account at $35,000, which is above the $30,000 minimum or maintenance margin. The next day, the price again increased 15 cents per bushel and our trader lost another $15,000. This loss reduced his equity to $20,000, which is below the $30,000 maintenance margin and he had to deposit $30,000 to bring his account back up to the initial margin of $50,000.

This unfortunate trader, who may be an elevator operator who is hedging 100,000 bushels of soybeans which he anticipates selling from his inventory at the end of June, may anticipate that the futures price is going to continue to increase, and he may attempt to close out his position by entering an order with his broker to buy 20 contracts of July soybeans. In a rapidly rising market, his broker may not find anyone who wishes to sell and our trader may be "locked-in."

The price of the July future rose to $11.51 per bushel on June 22 and if he had waited until that time to close out his account, he would have had to deposit some $589,250 to cover losses of $457,750 and to meet an initial margin which the Board had increased to $150,000 and a maintenance margin which the Board had increased to $75,000.

Although the foregoing is just an illustration, the data used in it are real. During the May-June time period, initial margin requirments were increased some 300 percent and maintenance margins were increased some 250 percent.

When margin requirements are increased in a rising market, the "shorts" (those who are selling or agreeing to either buy back their contract or deliver the commodity at a later date) upon being called upon to make margin payments, are more likely to try to make liquidating purchases, thereby increasing demand on the long side and resulting in still higher prices.

In addition, the rapid and substantial price increases caused by the market disruptions required the short hedgers to obtain funds at increasing interest costs to meet margin calls to hold their hedged positions in the futures market.

2. *Multiple Delivery Points*

Under the Commodity Exchange Act, only the exchanges may designate the point or points for delivery of commodities in fulfillment of a futures contract. Although some futures contracts do provide multiple or alternate delivery points, major futures contracts such as those for corn and soybeans provide that such commodities may only be delivered at Chicago.

During periods of short supply or when transportation is a problem, sellers are at a disadvantage if there is only one delivery point. For example, a large volume of corn was hedged in the July 1973 futures contract. When local elevators made those contracts, they agreed to either buy back the contract or deliver the grain between July 20 and the 10 days following. Under the terms of the corn contract, delivery could only be to one of several delivery sites, all of which are in Chicago. The elevator operator or seller of the contract, who is described as being on the short side of the contract, must either deliver the grain within that time or pay whatever is necessary to buy back the contract. Speculators or exporters or others who have bought such contracts are described as being on the long side of the contract and they may demand delivery of the corn or agree on a price at which they will sell back the contract.

At the time the July 1973 contract expired, corn was readily available in Iowa at about $2.25 per bushel but there simply was no transportation available to deliver that volume of grain to Chicago within a few days and the delivery sites named in the contract could not have handled the delivery of that volume anyway. Since the shorts could not deliver corn in fullfillment of the contract, the holders of the long side of the futures contracts were able to demand as much as $1.30 per bushel more for their contracts than the corn would have cost if it could have been delivered. This is a situation where transportation alone caused most of the problem.

Obviously a need exists to provide multiple or alternate delivery points, as the July corn situation could have been avoided if the futures contract had permitted delivery at some alternate delivery points in the grain surplus area such as Des Moines and Peoria, permitting delivery to be made by truck where corn was available, that is, in the interior of the country, instead of requiring that delivery be made in Chicago.

Establishment of an adequate number of delivery points which have adequate transportation and storage facilities, would contribute substantially to preventing, or at least reducing, the possibility of price manipulation and market congestion. Although the exchanges probably have a greater expertise to determine the need for and the location of delivery points, it is apparent that Federal agency oversight of their action, or nonaction as the case may be (such as is shown by the continued failure of the Chicago Board of Trade to establish additional delivery points for corn), is necessary. In spite of the evidence of need, the Chicago Board still has not voluntarily established adequate additional delivery points for corn and the new commission will need to address itself to this problem.

3. *Speculative Limits*

Due to the possibilities of market manipulation and the danger of price fluctuation, the Commodity Exchange Act recognized that excessive speculation is an unnecessary burden and authorizes the establishment of limits to diminish, eliminate, or prevent such burden. Using this authority, the Commodity Exchange Commission restricted the amount of soybean futures or corn futures which may be owned by any one trader, the position limit, to 3 million bushels and the amount of soybeans or corn which may be traded by any one trader on 1 day to 3 million bushels. Similarly, the Commodity Exchange Commission established a 2 million bushel position limit for wheat and a 2 million bushel per day trading limit on wheat. For some reason, however, limits were not established for all commodities regulated by the Act, some of the major ones being live cattle and frozen pork bellies.

A periodic review of each commodity to determine the validity of the existing speculative limits and to set limits for those without such limits would prevent the loss of this protection from price manipulation because a speculative limit did not reflect the market environment of the commodity it was designed to protect. Thus, it would appear advantageous to establish speculative limits in all regulated commodities and to periodically review and modify all speculative limits.

4. *Double Hedging*

Excessive speculation in any futures contract can cause sudden or unreasonable price changes or fluctuations to the detriment of the traders and the consuming public, and speculative limits have been set in certain commodities to prevent this from happening. Thus, supposedly, a trader cannot buy and sell nor may he own at the end of the day contracts in excess of 3 million bushels of soybeans or corn unless he is a bona fide hedger. For wheat, oats, barley, and flaxseed, the limit is 2 million bushels; and the limit for cotton is 30,000 bales.

This restriction on futures trading only applies to speculators; it does not apply to hedgers, those who use the futures markets to guard against price fluctuations in commodities which, as part of their normal business operations, they will be buying or selling.

Under the interpretations of the statutes and the regulations by the CEA, a person who had inventories, purchase commitments and/or sales commitments could hedge all of these commitments on both sides or any combination of these cash positions in the futures markets. This gave large commodity houses the ability to, in effect, speculate with legally hedged positions.

An illustration of the inherent dangers in permitting double hedging, that is, hedging one side of a cash position but ignoring the other, is shown by the following. One large trader in its reports to the CEA showed that it had an inventory of 33 million bushels of soybeans, had contracted to purchase another 62 million bushels at fixed prices, and had contracted to sell 60 million bushels at fixed prices. Good business practice would dictate that these sales should have been made at prices sufficient to lock in a desired profit. At that point, if the sales obligation is subtracted from the inventory and purchase obligations, it can be seen that the company had offset its risks so that it would not lose or gain by changes in market price for 60 million of its cash soybeans. It could only lose or gain on its net risk, some 35 million bushels, the amount which it owns after subtracting its sales commitments.

Under the rules of the CEA, however, that company could use the commodity futures market to sell 95 million bushels of soybeans to offset its inventory of 33 million bushels and its purchase commitments of 62 million bushels, and it could also buy 60 million bushels to offset its sales commitments of 60 million bushels. If it did both, it would be in a fully hedged position.

In this situation, however, in using the futures market to hedge, the company sold 4 million bushels of soybean futures and purchased 39 million bushels. This meant that the company was, in effect, speculating in the futures market to the tune of 35 million bushels. If the price of soybeans increased, the company would gain not only on its 35 million bushel long position in the cash market, that is, ownership of the actual soybeans, but it would also gain on its 35 million bushel long position in the futures market. Of course, if the price of soybeans dropped, the company would suffer a loss on both the cash and futures market, but apparently it was willing to gamble on a price increase.

The net effect of this use of double hedging is to permit a company with substantial purchase and sales commitments to speculate far in excess of the 3 million bushel limit.

In order to decrease their ability to exert speculative pressure on futures prices, it would be necessary to restrict hedgers to off-setting their net risk positions either by commodity or even by crop year in each commodity.

Because a net risk test is not applied to determine if a trader is buying and selling futures as a speculator or as a bona fide hedger, large traders are permitted to speculate far in excess of the speculative limits. Redefining hedging to cope with abuses will be a major responsibility of the new commission under its authority.

5. *Associations of Futures Commissions Merchants*

The old Commodity Exchange Act provided some limited protection to the public by requiring that those who deal in commodities as brokerage firms (futures commission merchants) or floor brokers, be registered with the CEA which could deny registration if the applicant is unfit.

The dangers to commodities customers whose accounts may be handled by dishonest, unscrupulous or unqualified individuals were evident. This is not meant as a criticism of FCMs or floor brokers, for they often unknowingly employ such individuals to the detriment of the trading public. Once the background of an unsuited individual is discovered by his employer, his employment is generally terminated but this does not solve the problem as not only may the damage have already been done, but the CEA found that dishonest individuals have a tendency to go from one firm to another. Thus, the problem is a never-ending one.

Criticism of the lack of standards of fitness for those who work for FCMs or floor brokers appears well founded and certainly justified. In order to adequately protect the investing public, registration requirements and fitness tests should be imposed on commodity solicitors, advisors, and all other individuals who are involved either directly or indirectly in influencing or advising the investment of customers' funds in commodities. This should include any individuals or organizations identified as influencing or actually investing funds in the commodities markets.

6. *Regulation of All Commodities*

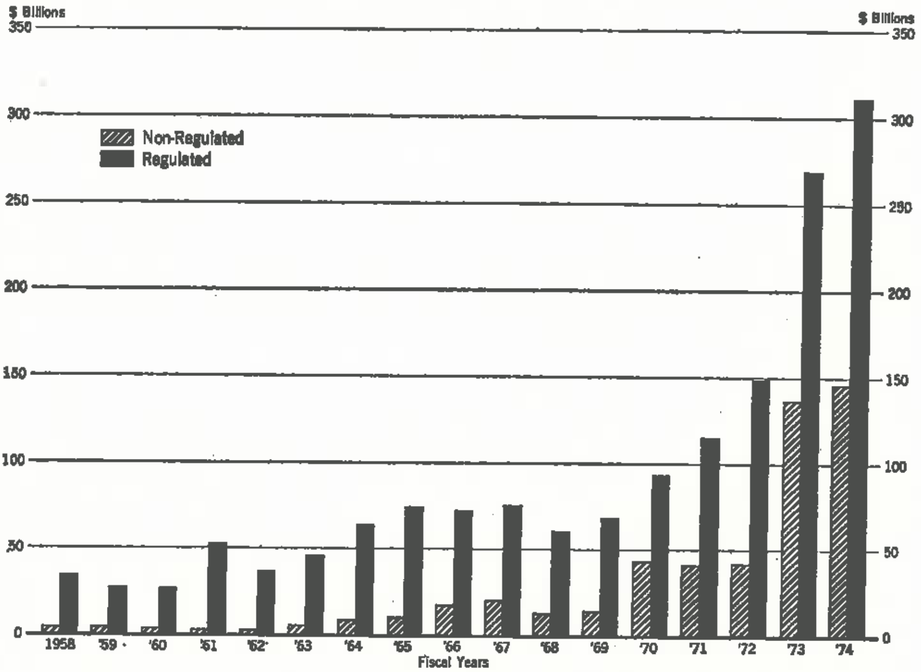
Both the number and the amount of commodities which are the subject of futures trading has mushroomed in less than two decades from less than $40 billion per year to approximately $500 billion per year. At the time of the hearings, the CEA estimated total trading for fiscal year 1974 at $455 billion, but others believed that this projection was low and estimated that futures trading would exceed $500 billion. Statistics released in August 1975 by Futures Industry Association, Inc., formerly the Association of Commodity Exchange Firms, Inc., reported trading volume in all commodities for fiscal year 1975 at $504,550,560,522. This tremendous growth can be easily seen on the following chart.

Not even the minimal amount of regulation of trading provided by the old Commodity Exchange Act applied to all futures contracts. The Act specifically enumerated some two dozen commodities in which futures trading was regulated, such as feeds and grains, livestock, eggs, frozen orange juice, Irish potatoes, and wool.

Those commodities not enumerated in the Act were nonregulated and included such major commodities as aluminum, copper, silver, and other metals, cocoa, lumber and plywood, and sugar. Trading in those nonregulated

CHART G

Estimated Value of Trading in Commodities Futures Contracts On Boards of Trade or Commodity Exchanges, Fiscal Years 1958-74



commodities had grown at even a faster rate than trading in regulated commodities, possibly because of newly developed needs for futures trading of these commodities but also due to the lack of Federal regulation; nonregulated commodities provided a haven for manipulators. The new Act covers previously unregulated commodities.

Stories of phenomenal gains and losses appeared regularly in the press. One account indicated that one commodity options firm with initial capital of $800 grossed about $45 million in a period of 18 months. According to these press accounts, the firm was put into receivership when officers of the firm charged the owner with attempting to illegally divert $641,000 of the customers' money to a foreign bank. In another instance, the press reported that a commodity options industry representative testifying before a State regulatory agency estimated that 50 to 60 percent of the present dealers would be put out of business if legislation were passed banning ex-felons, individuals previously convicted of fraud, and other questionable characters from selling options.

Trading in puts and calls for commodities regulated by the Act has been prohibited since 1936, and while the CEA was aware of the trading in puts and calls in nonregulated commodities, it had no authority to oversee such trading. In view of the serious risk of financial loss to brokerage firms, however, the

CEA did take action designed to protect the customer funds of those trading in futures regulated by the Act. Effective January 2, 1974, the CEA prohibited a registered brokerage firm from underwriting, issuing, or otherwise assuming any financial responsibility for the fulfillment of "puts" and "calls" transactions.

7. *Economic Demonstration for Futures Contracts*

Effective October 1, 1973, each contract market was required to file with the CEA, at least once every 5 years, a statement with supporting data showing the provisions that it has made to continue to comply with the conditions and requirements of section 5 of the Act for designation as a contract market for a specified commodity. However, even the stated minimum requirements under the old law did not include reference to serving a useful economic purpose. Section 3 of the Act, which details the basis for Federal regulations of commodity exchanges, emphasizes the economic role of trading in commodity futures contracts.

Under the new Act, this economic role is made a condition precedent to futures trading in a commodity, and the new commission now has a basis for refusing to designate a new contract market that serves no useful economic purpose or revoking the designation of a contract market that no longer serves any economic purpose.

D. *Revitalization of the Commodity Exchange Commission*

When the Federal provisions were enacted to regulate futures trading, the commodity futures industry was in its infancy. The value of the commodities being traded was very small and was confined mainly to agricultural products.

The number of individuals involved in futures trading was also very small and most of them had considerable expertise in both the commodities they were trading and the manner in which the exchanges operated. Hence, possibly during those early times the need for regulation of the commodity futures industry was not as great and possibly it was sufficient for it to be done by an inactive Commission composed of the Secretaries of Agriculture and Commerce and the Attorney General, with the administration of the CEA being delegated to an Administrator whose unit would function as a minuscule part of the vast Department of Agriculture.

Despite the existence of any circumstances which previously justified a "laissez faire" attitude toward commodities futures, today's market clearly demands that regulation be by a full-time regulatory agency. Monitoring the fast moving $500 billion commodities market requires that the members be available on an around-the-clock basis for those unusual actions which should only be taken with approval of the full Commission. The commodity markets have several expiring contracts each month and continuing surveillance is necessary to avoid squeezes and manipulations. Commission actions taken to prevent a squeeze may affect our whole economy. In some cases, timeliness of an action is as important as the action itself; and when action is needed, there will not, on many occasions, be time to wait for commissioners to assemble from various corners of the United States.

Without going into the details of its duties and responsibilities, it appeared obvious that the agency needed was one with members who are without other constraints on their time and who are able to meet whenever necessary and on a regular basis.

It also appeared that since the commodities being traded were no longer just agricultural in nature, there was no need for the agency to be part of the Department of Agriculture and subject to the influence of the executive branch. The agency could best fulfill its regulatory responsibilities by having a stature similar in nature to the other independent regulatory agencies such as the Securities and Exchange Commission.

Merely changing the Commission to a larger dependent agency with full-time members would not have rectified the problems. In addition, a new agency would be in dire need of adequate staffing and adequate tools with which to perform its function of policing the commodities futures markets.

1. *Effective Enforcement Powers*

Even when the CEA detected marketing practices which frustrated the purposes for which the commodity markets exist, it did not secure injunctions to stop such practices. For example, during the 1972 marketing year, the prices of soybean contracts rose rapidly at the same time that a small number of traders dominated the long side of the market requiring delivery. The number of longs clearly exceeded the ability of shorts to deliver or offset especially since toward the end of May three traders controlled over 50 percent of the July long positions and by the second week in June three traders controlled 60 percent of the same positions.

During this period, the Chicago Board of Trade tried to meet the situation by raising margin and maintenance deposits. The margin deposit on soybeans was increased from 40 cents per bushel earlier to $1.50 on June 22, and the maintenance deposit was increased from 30 cents per bushel to 75 cents per bushel. This increased the requirements for borrowing and the interest cost for genuine hedgers. In some cases where the elevator operators were able to meet these margin calls, the interest cost to these hedgers jumped to double the total amount they had reserved for their total gross profit. In other cases, they could not meet the margin calls and were forced to buy the hedges back and sell cash grain even though no transportation was available.

People in the trade knew that the CEA would not move decisively on any of these matters and, therefore, oftentimes ignored the agency's officials when they sought to stop abuses. One situation was described to the Subcommittee where a CEA official stood beside a trader who was committing what appeared to be a violation, and he therefore asked him to stop, but the trader ignored the CEA employee's request.

Injunctive authority in the hands of the Commission should encourage the exchanges to make a more diligent effort to find an appropriate response to such circumstances and can provide a decisive course of action without the legitimate hedger paying such a high price.

2. *Unencumbered Legal Proceedings*

The lack of ability to move rapidly was a problem in both investigation and enforcement activities. This is well illustrated by the Kansas City wheat case,[6] and by another situation in which consent orders were issued against violators some two years after attempted manipulations in May 1971 Idaho potato futures on the Chicago Mercantile Exchange (CME). CME officials stated the control of manipulation or suspected manipulation is directly related to the speed with which any suspected situation is brought under surveillance, and they recommended that the CEA more rapidly initiate and conclude its investigations.

One of the key prerequisites to timely action to enforce the Act is the ability to rapidly move into the judicial system, which in turn depends upon the attorneys who are to handle the action. Often, time is of the essence in securing an injunction and any unnecessary delay could very well mean the loss of the best remedy. Also, the problems these attorneys will be handling will be complicated and will require special knowledge of market operations. It was essential that the Commission be given the authority to bring legal action in the name of the Commission and through its own attorneys.

The alternative to this would be referral of the matter to the Justice Department. Clearly this arrangement would not work as effectively as the Department of Justice lacks a sufficient staff (and the expertise) to move promptly as can be illustrated by the many cases which languished there, such as the alleged Kansas City wheat manipulation.

3. *Civil Money Penalties*

Once an investigation had been completed, the CEA had to determine what penalty should be assessed and whether the case should be referred to the Department of Justice for criminal prosecution. Under the old Commodity Exchange Act, there was a great spread between the minimum and maximum sanction which could be applied. For example, if any contract market did not enforce its rules of government, or if any contract market, or any director, officer, agent, or employee of a contract market otherwise violated any of the provisions of the Act or any of the rules, regulations, or orders of the Secretary of Agriculture or the Commission, the Commission could, upon notice and

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6. *See* section V.A., *infra*.

hearing subject to appeal, make and enter an order directing that such contract market, director, officer, agent, or employee cease and desist from such violation. If the contract market, director, officer, agent, or employee failed or refused to obey or comply with the order, he would be guilty of a misdemeanor and, upon conviction, be fined not less than $500 nor more than $10,000 or imprisoned for not less than six months nor more than 1 year, or both. In addition, the designation of a contract market could be suspended for up to six months or revoked for failure or refusal to comply with any of the provisions of the Act, or any rules, regulations, or orders of the Secretary of Agriculture or the Commission. Thus, if an exchange violated the law, the minimum penalty was merely a cease and desist order while the maximum would be a revocation of an exchange's designation as a contract market, thereby putting it out of business. The latter was obviously such a drastic step that the exchanges were confident the CEA would not revoke its designation merely for minor violations.

Thus, in many instances, the CEA could as a practical matter, only threaten severe sanctions or do nothing at all. This lack of effective sanctions may explain why the U.S. Department of Agriculture issued only 129 complaints since 1960 as part of the CEA's enforcement efforts.

Obviously, the new authority to impose civil money penalties or more modern sanctions should, in all likelihood, be used more and be a greater deterrent toward preventing some of the current abuses.

E. *Evaluation of CEA and Exchange Enforcement Activities*

1. *Market Surveillance*

As part of the CEA's market surveillance efforts, the CEA obtained and analyzed reports from "large traders." For those trading in grain, a large trader was one who held a position of 200,000 bushels or more in any one grain future. In addition to daily reports on their futures trading, these "large traders" reported their cash market positions to the CEA on a weekly basis. The CEA then prepared weekly surveillance reports analyzing factors in the various markets.

It is evident that the CEA largely relied upon the exchanges to regulate themselves and there was opposition to the establishment of a CEA surveillance agency with the ability to constantly monitor the operations of the exchanges. In the years before some traders dealt in large volumes and when there were surpluses of most commodities, the opportunities for manipulations and squeezes were not as prevalent, but the situation has changed.

A good example of the lack of adequate and accurate enforcement activities is presented by the Kansas City wheat case:

1. On July 28, 1972, the CEA received a complaint alleging manipulation of the Kansas City September future, and on the same day,

it was referred to the CEA Regional Office in Kansas City with a directive to start an investigation with "the highest priority."

2. On August 15, 1972, the CEA Regional Office communicated with the Kansas City Board of Trade and asked them to conduct an investigation of the matter.
3. On September 27, 1972, the CEA Regional Office was advised by the Kansas City Exchange that their investigation showed that the market had functioned properly and there were no indications of price manipulation.
4. Finally, 9 months later on April 30, 1973, the CEA completed its own investigation and came to a conclusion opposite that of the Kansas City Board of Trade. The CEA found that the market had been manipulated on the close for several days resulting in the payment of millions of dollars more in export subsidies.
5. On May 23, 1973, the matter was referred to the Justice Department, where it is still languishing, awaiting action.

This situation is not an isolated example. In a 1971 report on CEA operations, the Inspector General of the U.S. Department of Agriculture had recommended that the CEA require regional offices to establish and maintain sufficiently effective systems of surveillance, analysis, and investigation to provide more expedient and effective action to prevent manipulation before commodity futures markets are disrupted; pursue all cases indicative of manipulation to proper conclusions; direct actions against the appropriate commodity exchanges as well as the offending traders; and require the commodity exchanges to provide and carry out more effective systems for the prevention of manipulation.

As of 1973 the Acting Inspector General, USDA, maintained that the CEA's market surveillance activities were still deficient. Officials of the Office of the Inspector General stated that the CEA's economic analyses of the maturing futures were not always conducted or documented to support reliable conclusions that the maturing futures had been liquidated at normal prices. These officials did not always agree with the CEA that manipulation had not occurred. They believed that the CEA's procedures for collecting trading data and assembling it into meaningful form for surveillance on a timely basis needed improvement. The CEA, in the Inspector General's view, lacked sufficient staff to properly or adequately analyze all maturing futures.

It was obvious from all of the above that an agency which would fully provide the surveillance necessary and the protection desired to assure businessmen that they will continue to have an efficient and economic place to reduce the risk on futures contracts would have to have a much greater capacity than the CEA.

2. *Floor Trading*

An order to buy or sell a commodities future contract is transmitted to a futures commission merchant (FCM) or floor broker, who will fill the order.

Under the provisions of the old Commodity Exchange Act the order was to be filled on the floor of the exchange by public outcry; and the FCM or floor broker was not permitted to take the other side of the contract. However, the floor broker who would fill this order was permitted not only to fill these customer orders, but could trade for himself or for the FCM for whom he worked.

Under the Commodity Exchange Act, a floor broker could trade for himself one moment and trade to fill customer orders the next. In addition, because an FCM could employ several floor brokers, one broker might be filling a customer order by trading with a floor trader who worked for the same FCM and who is making the trade for himself.

Along a related line, a FCM could maintain a house account and trade for itself at the same time it is advising customers, soliciting and filling customer orders. This situation was ripe for abuse and in the event that the customer received a bad trade, subjected the FCM to considerable suspicion as to its conduct.

Moreover, under this system of dual trading, the opportunities for accommodations between traders, for scalping, for three-cornered deals, and for any number of abuses were so great as to stagger the imagination. To make matters worse, in most cases it was almost impossible to secure the evidence necessary to prove that such traders had violated the rules.

This area, which abounds with conflict of interest situations, was one of the major areas of concern to the General Accounting Office in their 1965 study. In their review of transactions at just one exchange, 47 instances of questionable trading practices were found to have occurred during a three-month period. Of these, subsequent investigations showed 19 instances where floor brokers (all of whom were employed by one FCM) had filled customers' orders noncompetitively by taking the opposite side of the transaction either for their own account or for the house account of the FCM.

This practice was also criticized in a June 1973 CEA management team study report which stated:

> Some of the customer complaints processed in the investigation branch of CEA deal with allegations of "bad fills" by floor brokers for customers. The temptation of floor brokers to give preferential treatment to proprietary accounts to the possible detriment of customers' orders should be eliminated. If floor brokers were restricted to trading only for one interest, there would be less chance for a conflict of interest. As a result, the market would benefit from a reduction in the number of customer complaints and from improved customer confidence.

3. *Trading Clubs*

A number of brokerage houses have plans to give specific advice or recommendations regarding trading in regulated commodities to certain customers who desire professional management or supervision of their trading. These customer-participants are not required—on paper—to follow specific recommendations. However, the plans are designed for best results when such recommendations are followed. Allegations were made that customer trading programs had been used in manipulative ventures and should be brought under tighter control by the CEA and the exchanges.

A futures commission merchant, broker, or other person who has discretionary power or control over other accounts is subject to the position limit for the commodity traded (for example, 3 million bushels of soybeans) on the basis of a single trader regardless of the number of accounts he controls. The key criteria for speculative limits are ownership and control; therefore, if members of a club operate in accordance with some implied or agreed understanding, then the position limits should apply to the club as if it were a single trader.

The inherent dangers of such clubs are obvious. If a broker had enough people moving in the same direction with each holding a substantial number of hedged positions, it is obvious that they could substantially distort the market under certain circumstances.

Speculative limits are applied to a trading plan and customers' accounts involved in a trading plan are combined for the purposes of determining the limit. However, the CEA had very limited information on the identity of such plans, especially when a club was not tightly enough organized to be easily detected, and moreover the CEA did not have the ability to effectively detect and move against such plans. Injunctive authority would be important in such a case because the CEA could then enjoin persons acting in concert instead of only punishing them after the CEA had developed the proof and held lengthy administrative hearings. A beefed-up surveillance mechanism both in terms of personnel and hardware was clearly needed to detect and check the tremendous number of potential abuses in this area.

4. *Lack of Effective Enforcement*

The importance of effective policing of trading on contract markets and the prevention of abuses cannot be underestimated. Effective policing is essential to free and effective markets and the prevention of cheating, fraud, and deceit by futures commission merchants and floor brokers in the handling and execution of customers' orders. Despite the provisions of section 5(a)(8) of the Act placing the primary responsibility of the enforcement of trading rules which prohibit price manipulation, cornering and squeezing the market, and the abusive trading practices, on contract markets themselves, the CEA treated these types of investigations as marginal activities and failed to see to it that contract markets carried out their obligations.

F. *Findings and Conclusions*

Based upon the testimony, the exhibits and other evidence supplied during the course of this study and investigation, the Subcommittee which I chaired found that the extent of futures trading and the nature of the futures industry had grown and changed so substantially that a new and revitalized regulatory agency was needed. This need was amply demonstrated by the growth of futures trading during the past decade, growth which had been so tremendous that it was estimated that the value of futures traded during 1974 exceeded $500 billion. The Subcommittee also noted that there is a high degree of concentration and domination by major grain firms who are multiproduct, multinational, and often multibillion dollar operations.

1. *Intervention by Foreign Interests*

There is a very real and very great danger that futures markets will be distorted and manipulated by foreign companies, some of which have access to the huge resources of foreign governments. If a big grain trading company sells to a foreign government, the grain company can hedge on our commodity markets by buying contracts on the long side. The CEA records would show them as hedging a sale but it would not be known for two weeks or longer who contracted for the grain, and even then the records do not show whether the foreign customer is really using the purchase for speculation or for consumption. By dealing with four or five big companies simultaneously, the way the Russians did, a foreign interest could buy at a fixed price almost an entire wheat crop as the grain companies who sold to them would not know at the time they signed their contracts at a fixed price, the extent to which other companies were obligating themselves on fixed contracts. As noted, this happened in the Russian grain deal, and Cargill representatives stated before the Subcommittee that although they assumed the Russians were negotiating with others, they had no idea that they were buying the quantity of wheat which they did.

Since the foreign companies could purchase and demand delivery of a huge amount at the fixed price, or wait until a later date and dump part of it, one can easily see how they could take delivery of as little as one-fourth of a big purchase and secure enough profit from the resale of the rest to pay for the grain actually needed. Since it is so easy for foreign customers with huge resources to do this and since large export companies under certain circumstances can legally share in the gain by double hedging, the Subcommittee believed a huge manipulation or distortion in some commodity would occur if steps were not taken soon to prevent it.

The Subcommittee thus concluded the Act should be amended to authorize the Commission to place such limits upon the amount of export sales which may be hedged as it deems necessary to prevent direct or indirect foreign speculation in domestic markets.

G. *Subcommittee Recommendations*

Based on the testimony and evidence presented during the hearings, the Subcommittee made the following legislative recommendations:

I. That the appropriate legislative committees consider amending the Commodity Exchange Act to:

A. Create a new full time independent regulatory agency with authority and responsibility to constantly exercise surveillance over the commodities markets and to prevent and correct abuses and manipulations. The agency should be given the authority to:

1. Seek an injunction in Federal courts to prevent violations of Federal statutes;
2. bring actions in its own name and through its own attorneys in the Federal courts in order to seek injunctions and enforce civil money penalties;
3. bring complaints against violators which could result in substantial civil money penalties and imprisonment;
4. require additional delivery points for commodities to assure that the speculators cannot demand more than cash value for commodities;
5. regulate the margin requirements;
6. take such action as necessary to prevent excessive speculation or cornering of a commodity futures market;
7. take such action as necessary to prevent foreign countries and companies from indirectly speculating in excess of the limits set for domestic customers; and
8. order exchanges to take such action as is necessary to facilitate the orderly trading in liquidating futures contracts.

B. Prohibit floor brokers and futures commission merchants from trading for themselves in any commodity in which they handle customer orders;

C. Require exporters of commodities to report the details of all sales to a foreign country or company within 48 hours and require the Commission to make this information available to the public the next day;

D. Authorize and require the General Accounting Office to conduct reviews and audits of the Commission and report thereon to Congress to help assure that the Commission is fulfilling its responsibilities;

E. Bring all commodities traded on the futures markets under regulation;

F. Require the operators of trading clubs to register with the Commission;

G. Require the Commission to establish speculative limits in all commodities traded on contract markets, modify existing limits, and provide for periodic review of each commodity to determine the validity of the existing speculative limits in order to prevent the possibility of price manipulation due to a speculative limit not reflecting the market environment of the commodity;

H. Require the economic role of a futures contract to be demonstrated and proven prior to commencement of futures trading in that commodity;

I. Redefine a bona fide hedge to restrict hedgers to offsetting their net risk positions either by commodity or even crop year in each commodity so as to decrease ability of large commodity houses to exert speculative pressure on futures prices;

J. Require registration and fitness tests for commodity solicitors, advisors, and other individuals who are involved either directly or indirectly in influencing or advising customers on investments in commodity futures; and

K. Require the Commission to disseminate on a daily basis information on total market positions of large traders.

II. Commodity Futures Trading Commission Act of 1974

At the time of the Small Business Committee hearings, the Committee did not have legislative authority; its function was to conduct studies and investigations and work with the appropriate executive agencies and departments and Congressional Committees to secure the necessary action. Consequently, I introduced legislation (H.R. 11195) as recommended by the Subcommittee.

This bill was referred to the House Committee on Agriculture which conducted hearings on it and related proposals. Many of the proposed changes, such as making the new Commission truly an independent agency rather than merely an arm of the Department of Agriculture and giving it authority to seek injunctions rather than to merely allow it to take remedial action, caused considerable controversy. Many interests did not want additional federal responsibility in this area and, naturally, the Exchanges were opposed to the loss in their autonomy which would result.

In the end, however, after a long and hard debate, a compromise was reached and on October 23, 1974, the President signed the Commodity Futures Trading Commission Act of 1974 as Public Law 93-463.[7]

A. *Section Analysis*[8]

The Commodity Futures Trading Commissioin Act of 1974, consists of four titles:

Title I—Commodity Futures Trading Commission;

Title II—Regulation of Trading and Exchange Activities;

Title III—Enabling Authority for Creation of National Futures Associations;

Title IV—Miscellaneous Provisions.

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7. For additional information see 3 U.S. Code Cong. & Ad. News 5843 (1974).

8. Adapted from the Commodity Futures Trading Commission Act of 1974, 7 U.S.C. §§ 1 *et seq.* (Supp. IV, 1974).

1. *Title I—Commodity Futures Trading Commission*

Sections 101[9] *and 102.*[10] *Commission; compensation*

Section 101 establishes a new Commodity Futures Trading Commission, consisting of a Chairman and four other Commissioners appointed by the President, by and with the advice and consent of the Senate. Not more than three of the Commissioners may be members of the same political party. The Commissioners are appointed for staggered terms of five years each, and must include persons of demonstrated knowledge in the production, merchandising, processing, or distribution of the goods, articles, services, rights, and interests covered by the Act.

Commissioners and employees are forbidden to accept employment or compensation from anyone subject to regulation or to engage in transactions of a character subject to regulation.

The Chairman is compensated at Executive Level III (currently $40,000 annually), and the other Commissioners at Executive Level IV (currently $38,000 annually).

The Commission has a General Counsel and an Executive Director who report directly to the Commission, serve at the pleasure of the Commission, and are compensated at Executive Level V (currently $36,000 annually).

Executive and administrative functions are vested in the Chairman subject to:

> (1) general policies and decisions of the Commission;
>
> (2) Commission approval of heads of major administrative units;
>
> (3) an exception for employees in the other Commissioners' immediate offices;
>
> (4) reservation of the Commission's functions with respect to revising budget estimates and determining allocation of appropriated funds according to major programs and purposes.

The Secretary of Agriculture appoints a liaison officer, who shall be an employee of the Office of the Secretary, for the purpose of maintaining liaison between the Commission and the Department. The Commission furnishes the liaison officer with appropriate office space and clerical help, and he has the right to attend and observe all deliberations and proceedings of the Commission. Likewise, the Commission establishes a separate office within the Department of Agriculture to be staffed with employees of the Commission for the purpose of maintaining liaison between the Department and the Commission. The Secretary is required to take such steps as may be necessary to enable the Commission to obtain information and utilize such services and facilities of the Department as may be necessary in order to maintain effectively such liaison.

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9. 7 U.S.C. §§ 2, 4, 16 (Supp. IV, 1974).
10. 5 U.S.C. §§ 5314, 5315, 5316 (Supp. IV, 1974).

When any budget estimate or request, legislative recommendation, or testimony, or comments on legislation is submitted to the President or the Office of Management and Budget, copies must be concurrently transmitted to House and Senate Committees.[11]

The Commission is authorized to cooperate with others; to employ a staff, including Administrative Law Judges; to employ experts and consultants; and to make and enter into contracts.

Sections 103[12] and 104. Transfer of functions

Powers vested under the Commodity Exchange Act in the Secretary of Agriculture and the Commodity Exchange Commission and personnel, property, records and funds employed in connection with administration of the Commodity Exchange Act are transferred to the new CFTC.

Section 105.[13] Annual reports; GAO examinations

The Commission is required to submit annual reports to Congress. The Comptroller General may examine any books, documents, papers, or records of the Commission and is required to provide Congress with reviews and audits of the Commission. With respect to business transactions of any person, trade secrets, and names of customers, the Comptroller General is forbidden to include such information in his reports. However, he could provide such information on request by any Committee of either house of Congress acting within the scope of its jurisdiction.

Section 106.[14] Reparations procedure

Administrative reparation proceedings are provided before the Commission for any person against persons registered as futures commission merchants, floor brokers, persons associated with futures commission merchants or with agents thereof, commodity trading advisors, or commodity pool operators. Up to two years after accrual of the cause of action, a complaint may be filed by any person, based on any violation of the Act or rules, regulations, or orders thereunder.

The Commission is required to send the complaint to the respondent who is then required to satisfy or answer it, if the Commission believes that the facts alleged warranted such action.

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11. A subsequent bill would have amended this by requiring that the Commission's original budget request be submitted to the Congressional Legislative and Appropriations Committees upon transmission to Congress of the Administration's budget estimate or request. The bill was favorably reported by the House Agriculture Committee on December 20, 1974, but no action was taken.
12. 7 U.S.C. §§ 1 *et seq.* (Supp. IV, 1974).
13. *Id.* §§ 12, 12-1.
14. *Id.* §§ 1 *et seq.*

The Commission is required to investigate the complaint if the Commission believes that there appears to be reasonable grounds for such investigation, and is permitted to have the complaint served on the respondent and afford the respondent an opportunity for hearing before an Administrative Law Judge. If the complainant claims not more than $2,500 in damages, proof in support of the complaint and in support of respondent's answer, may be supplied by depositions or verified statements of fact.

The Commission is required to determine whether or not the respondent has committed any violation of the Act or rules, regulations, or orders thereunder. If the Commission determines that he has committed such a violation, it is required to determine the damages to which the complainant is entitled as a result of the violation, and to order the respondent to pay such damages to the complainant.

If the respondent admits liability for a portion of the damages claimed, the Commission may order the respondent to pay the undisputed amount and subsequently determine liability for the disputed amount.

If a reparation award is not paid, the person for whose benefit it is made, has three years to file a certified copy of the Commission's order in the United States district court for the district of his residence or the district where respondent has its principal place of business, for enforcement of the award by appropriate orders. Subject to a specified right of appeal, an order of the Commission awarding reparations is final and conclusive.

Judicial review of the Commission's findings and order is on appeal, only in the Court of Appeals pursuant to the procedure provided in section 6(b) of the Commodity Exchange Act. Under section 6(b) of the Act, the findings of the Commission, as to the facts, are, if supported by the weight of the evidence, conclusive.

Unless the registrant against whom a reparation order is issued, pays the award or appeals it, he is prohibited from trading on contract markets, and his registration will be suspended automatically.

The section becomes effective one year after enactment, but claims arising within nine months before the effective date could be heard by the Commission after such one-year period.[15]

Section 107.[16] *Antitrust laws*

The Commission is required to consider the public interest to be protected by the antitrust laws and endeavor to take the least anticompetitive means of achieving the objectives of the Act in issuing or adopting any rule or regulation, or requiring or approving any bylaw, rule, or regulation of a contract market.

15. An amendment delayed the effective date of this section to fifteen months after enactment and the date of claims to those arising one year after enactment. Act of April 16, Pub. L. No. 94-16, § 3, 89 Stat. 77, *amending* 7 U.S.C. § 18 (1970) (codified at 7 U.S.C. § 18i (Supp. IV, 1974)).

16. 7 U.S.C. §§ 1 *et seq.* (Supp. IV, 1974).

2. *Title II—Regulation of Trading and Exchange Activities*

Section 201.[17] *Regulated commodities; jurisdiction*

The definition of "commodity" in the Commodity Exchange Act is enlarged to include all goods and articles, except onions, and "all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in," and the Commission is given exclusive jurisdiction over all futures transactions which are executed on domestic boards of trade. The Commission has exclusive jurisdiction over options trading in commodities, but not in securities.

Transactions in foreign currency, security warrants and rights, resales of installment loan contracts, repurchase options, government securities or mortgages and mortgage purchase commitments are not subject to the Act unless they involve the sale thereof for future delivery conducted on a board of trade.

There is also a proviso that "except as hereinabove provided" nothing contained herein shall supersede or limit the jurisdiction at any time conferred on the Securities and Exchange Commission or other regulatory authorities under the laws of the United States or of any State or restrict them from carrying out their duties and responsibilities in accordance with such laws. Likewise, nothing in this section supersedes or limits the jurisdiction of any Federal or State court.

The Commission is given exclusive authority pursuant to section 217 to regulate transactions for the delivery of silver bullion, gold bullion, or bulk silver coins or bulk gold coins pursuant to standardized margin or leverage contracts.

Section 202.[18] *Definitions of "commodity trading advisor" and "commodity pool operator"*

"Commodity trading advisor" is defined as any person who, for compensation or profit, engages in the business of advising others, either directly or through publications or writings, as to the value of commodities or as to the advisability of trading in any commodity for future delivery on or subject to the rules of any contract market, or who, for compensation or profit, and as part of a regular business, issues or promulgates analyses or reports concerning commodities. The term does not include any of the following, provided that their furnishing of such services is solely incidental to the conduct of their business or profession: (1) any bank or trust company, (2) any newspaper reporter, newspaper columnist, newspaper editor, lawyer, accountant, or teacher, (3) any floor broker or futures commission merchant, (4) the publisher of any bona fide newspaper, news magazine, or business or financial publication of

17. *Id.* §§ 2,4.
18. *Id.*

general and regular circulation including their employees, and (5) any contract market.

"Commodity pool operator" is defined as any person engaged in a business which is of the nature of an investment trust, syndicate, or similar form of enterprise, and who, in connection therewith, solicits, accepts, or receives from others funds, securities, or property, either directly or through capital contributions, the sale of stock or other forms of securities, or otherwise, for the purpose of trading in any commodity for future delivery on or subject to the rules of any contract market.

Section 203.[19] *Dual trading by floor brokers and futures merchants*

The Commission is required to determine, after notice and opportunity for hearing, within six months[20] after the effective date of the Act, and subsequently when it determines that changes are required, whether a floor broker may trade for his own account or any account in which such broker has trading discretion, and also execute a customer's order. If the Commission determines that such trades and executions shall be permitted, it is required to determine the terms, conditions, and circumstances under which such trades and executions shall be conducted.

The Commission is also required to determine, after notice and opportunity for hearing, within six months[21] after the effective date of the Act, and subsequently when it determines that changes are required, whether a futures commission merchant may trade for its own account or any proprietary account, as defined by the Commission. If the Commission determines that such trades shall be permitted, it is required to determine the terms, conditions, and circumstances under which such trades shall be conducted.

Any such determination, with respect to either floor brokers or futures commission merchants, is required at a minimum to take into account the effect upon the liquidity of trading of each market. The Commission is permitted to make separate determinations for different contract markets, and contract markets are permitted to set terms and conditions more restrictive than those set by the Commission.

Section 204.[22] *Registration of associates*

Persons associated with any futures commission merchant (or with any agent of a futures commission merchant) as a partner, officer, or employee (or persons registered as futures commission merchants or floor brokers are not re-

19. *Id.* § 6j.
20. Upon amendment, the time within which the Commission is required to make the determination was extended to nine months. Act of April 16, 1975, Pub. L. No. 94-16, § 2, 89 Stat. 77, *amending* 7 U.S.C. § 6j (1970) (codified at 7 U.S.C. § 6j (Supp. IV, 1974)).
21. *Id.*
22. 7 U.S.C. §§ 6k, 9, 12a(1) (Supp. IV, 1974).

quired to register as such associates), in any capacity which involves "(i) the solicitation or acceptance of customers' orders (other than in a clerical capacity) or (ii) the supervision of any person or persons so engaged" are required to register with the Commission. The Commission is authorized to require reporting by such persons. Such registration expires two years after the effective date thereof, and the Commission is required to renew it on application unless the registrant is under suspension or revocation. With respect to initial registrations, however, the Commission is required to set the effective period, not to be more than two years or less than one year from the effective date thereof.

Section 205.[23] *Regulation of commodity trading advisors and commodity pool operators*

Activities of commodity trading advisors and commodity pool operators are deemed to affect the national public interest in that, *inter alia,*

> (1) their advice, counsel, publications, writings, analyses, and reports are furnished and distributed, and their contracts, solicitations, subscriptions, agreements, and other arrangements with clients take place and are negotiated and performed by the use of the mails and other means and instrumentalities of interstate commerce;
>
> (2) their advice, counsel, publications, writings, analyses, and reports customarily relate to and their operations are directed toward and cause the purchase and sale of commodities for future delivery on or subject to the rules of contract markets; and
>
> (3) the foregoing transactions occur in such volume as substantially to affect transactions on contract markets.

Such persons are required to register but an exemption is provided for any commodity trading advisor who, during the course of the preceding 12 months has not furnished commodity trading advice to more than 15 persons and who does not hold himself out generally to the public as a commodity trading advisor.

The Commission is authorized to prescribe the information, and in what form and detail, such persons must supply in applying for the required registration. The minimum information required includes:

> (A) the name and form of organization, including capital structure, under which the applicant engages or intends to engage in business; the name of the State under the laws of which he is organized; the location of his principal business office and branch offices if any; the names and addresses of all "partners, officers, directors, and persons performing similar functions" or, if the applicant be an individual, his name and address; and the number of employees;
>
> (B) the education, the business affiliations for the past ten years and the present business affiliations of the applicant and of his partners, officers, directors, and persons performing similar functions and of any controlling person thereof;

23. *Id.* §§ 6e-o, 9, 12a(1).

(C) the nature of the business of the applicant, including the manner of giving advice and rendering of analyses or reports;

(D) the nature and scope of the authority of the applicant with respect to clients' funds and accounts;

(E) the basis upon which the applicant is compensated.

Registration is effective no more than 30 days after application, unless denied as provided elsewhere in the Act.

Registrations of commodity trading advisors and commodity pool operators expire on the 30th day of June of each year, and are renewed upon application therefor subject to the same requirements as in the case of an original application.

The Commission is authorized to prescribe recordkeeping and reporting requirements for such persons, who would be required to keep the prescribed books and records for at least three years or longer if the Commission so directs. The prescribed books and records are open to inspection by any representative of the Commission or the Department of Justice. On request of the Commission, a registered commodity trading advisor or commodity pool operator is required to furnish the name and address of each client, subscriber, or participant, and submit samples or copies of all reports, letters, circulars, memoranda, publications, writings, or other literature or advice distributed to clients, subscribers, or participants, or prospective clients, subscribers, or participants.

Futures market positions taken or held by individual principals of commodity trading advisors and commodity pool operators are required to be fully and completely disclosed to subscribers, clients, or participants, unless otherwise authorized by the Commission by rule or regulation.

Statements of account are required to be furnished regularly to each participant in the operations of every commodity pool operator. Such statements must include complete information as to the current status of all trading accounts in which the participant has an interest. The Commission is empowered to prescribe the form and manner of such statements.

Denial, without hearing, of registration as a commodity trading advisor or commodity pool operator is authorized for any person who is subject to an outstanding order under the Act, denying him trading privileges on any contract market, or suspending or revoking his registration as a commodity trading advisor, commodity pool operator, futures commission merchant, or floor broker, or suspending or expelling him from membership on any contract market.

Denial, revocation, or suspension, after hearing, of registration of any commodity trading advisor or commodity pool operator is authorized if the Commission finds that such denial, revocation, or suspension is in the public interest and that—

(A) the operations of such person disrupt or tend to disrupt orderly marketing conditions, or cause or tend to cause sudden or unreasonable fluctuations or unwarranted changes in the prices of commodities;

(B) such person (or any partner, officer, director, person performing similar function, or controlling person thereof)—(i) has been convicted within ten years of any felony or misdemeanor involving the purchase or sale of any commodity or security, or arising out of his conduct as a commodity trading advisor or commodity pool operator; or (ii) is under court injunction from acting as a commodity trading advisor, commodity pool operator, futures commission merchant, or floor broker, or affiliated person or employee of any of them, or from engaging in or continuing any conduct or practice in connection with such activity or in connection with the purchase or sale of commodities or securities; or

(C) any partner, officer, or director of such person, or any person performing a similar function or any controlling person thereof, is subject to a Commission denial of trading privileges on any contract market, or a Commission suspension or revocation of registration as a commodity trading advisor, commodity pool operator, futures commission merchant, or floor broker, or a Commission suspension or expulsion from membership on any contract market.

Registrants as commodity trading advisors or as commodity pool operators are prohibited by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly, from employing any device, scheme, or artifice to defraud any client or participant or prospective client or participant, or engaging in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or participant or prospective client or participant. Such registrants are also forbidden to represent or imply that they have been sponsored, recommended, or approved, or that their abilities or qualifications have been passed upon, by the United States or any agency or officer thereof, but are permitted to state that they are registered under the Act as a commoditiy trading advisor or commodity pool operator, if such statement is true in fact and if the effect of such registration is not misrepresented.

Administrative disciplinary proceedings may be instituted and administrative disciplinary orders issued against persons registered as commodity trading advisors and commodity pool operators for manipulation or attempt to manipulate the market price of any commodity, in interstate commerce, or for future delivery on or subject to the rules of any contract market, or for willfully omitting to state in any such application or report any material fact which is required to be stated therein, or for otherwise violating any of the provisions of the Act or of the rules, regulations, or orders thereunder.

Section 8a of the Act is made applicable to commodity trading advisors and commodity pool operators. Section 8a of the Act authorizes registration of futures commission merchants and floor brokers upon application in accordance with rules and regulations and in form and manner to be prescribed by regulation. It also authorizes the refusal to register any person—

(A) if the prior registration of such person is under suspension or revocation;

> (B) if it is found, after opportunity for hearing, that the applicant is unfit to engage in the business for which the application for registration is made, (i) because such applicant, or, if the applicant is a partnership, any general partner, or, if the applicant is a corporation, any officer or holder of more than ten per centum of the stock, at any time engaged in any practice of the character prohibited by the Act or was convicted of a felony in any State or Federal court, or was debarred by any agency of the United States from contracting with the United States, or the applicant willfully made any material false or misleading statement in his application or willfully omitted to state any material fact in connection with the application, or (ii) for other good cause shown.

Section 8a further provides for suspension or revocation of the registration of any person registered under the Act if cause exists under (B) above which would warrant a refusal of registration of such person.

Section 206.[24] *Qualifications of futures commission merchants, floor brokers, and their associates*

The Commission is authorized to specify by rules and regulations appropriate standards with respect to training, experience, and other qualifications which the Commission finds necessary or desirable to ensure the fitness of futures commission merchants, floor brokers, and persons associated with them. The Commission is empowered to prescribe the adoption of written proficiency examinations to be given to applicants for registration as futures commission merchants, floor brokers, and persons associated with them, and to establish reasonable fees to be charged to such applicants to cover the administration of such examinations.

The Commission is authorized further to prescribe that in lieu of examinations administered by the Commission, contract markets and registered futures associations may adopt written proficiency examinations to be given to such applicants and charge reasonable fees to such applicants to cover the administration of such examinations.

Under a "grandfather" clause, the Commission is authorized to specify terms and conditions for affording exception to a written proficiency examination to an individual who has previously demonstrated proficiency and skill, through training and experience, necessary to protect the interests of customers.

Section 207.[25] *Additional requirement for designation of a board of trade as a contract market*

A board of trade, before designation as a contract market, is required to demonstrate that futures transactions in the commodity for which designation is sought, will not be contrary to the public interest.

24. *Id.* § 6p.
25. *Id.* § 7(g).

Section 208.[26] *Satisfaction of futures contracts; warehouse receipts; delivery points—miscellaneous provisions*

Warehouse receipts are not required under section 5a(7) to be accepted in satisfaction of a futures contract unless the commodity in question may be delivered from a warehouse subject to the United States Warehouse Act.

Each contract market is required to permit the delivery of any commodity, on futures contracts, of such grade or grades, at such point or points and at such quality and locational price differentials as will tend to prevent or diminish price manipulation, market congestion, or the abnormal movement of such commodity in interstate commerce. The Commission is also required, if after investigation it finds that the rules and regulations adopted by a contract market permitting delivery of any commodity on futures contracts do not accomplish the objectives of the subsection, to notify the contract market of its finding and afford the contract market an opportunity to make appropriate changes in such rules and regulations.

If the contract market within 75 days of such notification fails to make the changes which in the opinion of the Commission are necessary to accomplish the objectives of the subsection, then the Commission is empowered to change or supplement such rules and regulations to achieve such objectives, after granting the contract market an opportunity to be heard.

Any such order would not, however, apply to contracts of sale for future delivery in any months in which contracts are currently outstanding and open. A contract market is afforded notice and opportunity to file exceptions to a proposed order determining the location and number of an additional delivery point or points.

Section 209.[27] *Contract market procedures on a customers' claims and grievances*

Each contract market is required to provide a fair and equitable procedure through arbitration or otherwise for the settlement of customers' (but not necessarily futures commission merchants' or floor brokers') claims and grievances against any member or employee thereof, the use of which by a customer would be voluntary. The procedure would not be applicable to any claim in excess of $15,000 and would not result in any compulsory payment except as agreed upon between the parties.

Section 210.[28] *Commission approval or disapparoval of contract market rules*

Each contract market is required to submit to the Commission for its prior approval before issuing or placing into effect all bylaws, rules, regulations, and

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26. *Id.* §§ 7a(7), (8), (9), (10).
27. *Id.* § 7a(11).
28. *Id.* § 7a(12).

resolutions made or issued by it, or by the governing board thereof or any committee thereof, which relate to terms and conditions in contracts of sale to be executed on or subject to the rules of such contract market or relate to other trading requirements, except those relating to the setting of levels of margin.

The Commission is given 30 days either to approve such bylaws, rules, regulations, and resolutions or to notify the contract market that it is unable to make the necessary determination within 30 days.

The Commission is required to approve such bylaws, rules, regulations, and resolutions upon a determination that they are not in violation of the provisions of the Act or the regulations of the Commission. Thereafter, the Commission is required to disapprove, after appropriate notice and opportunity for hearing, any bylaw, rule, regulation, or resolution which the Commission finds at any time is in violation of the provisions of the Act or the regulations of the Commission.

A contract market is empowered to issue without prior Commission approval a rule dealing with an emergency requiring immediate action, with notice and a complete explanation to the Commission. The Commission must specify the terms and conditions under which a contract market may, in an emergency, adopt a temporary rule dealing with trading requirements without prior Commission approval.

Regulations are authorized exempting enumerated types of contract market operational and administrative rules from the submission requirement.

Section 211.[29] *Restraining orders, injunctions, writs of mandamus, or orders affording like relief*

Whenever it appears to the Commission that any contract market or other person has engaged, is engaging, or is about to engage in any act or practice constituting a violation of any provision of the Act or any rule, regulation, or order thereunder, or is restraining trading in any commodity for future delivery, the Commission may bring a court action to enjoin such act or practice, or to enforce compliance with the Act, or any rule, regulation or order thereunder.

United States district courts and United States courts of territories and other places subject to the jurisdiction of the United States, are given jurisdiction to entertain such actions, and jurisdiction to issue writs of mandamus, or orders affording like relief, commanding any person to comply with the provisions of the Act or any rule, regulation, or order of the Commission thereunder, including the requirement that such person take such action as is necessary to remove the danger of violation of the Act or any such rule, regulation, or order.

Any action could be brought in the district wherein the defendant is found or is an inhabitant or transacts business or in the district where the act or

29. *Id.* § 13a-1.

practice occurred, is occurring, or is about to occur, and process in such cases could be served in any district in which the defendant is an inhabitant or wherever the defendant could be found.

The courts are prohibited from issuing such orders ex parte.

In lieu of bringing actions itself, the Commission may request the Attorney General to bring the action. Where the Commission elects to bring the action, it must inform the Attorney General and advise him of subsequent developments.

Section 212.[30] *Civil money penalties; increase of maximum fines*

The Commission is authorized to assess civil penalties of not more than $100,000 for each violation of the Act, or of the rules, regulations or orders thereunder. Appeals to the United States Courts of Appeal, from administrative disciplinary orders, must be filed within 15 days after the notice of such an order is given to the offending person.

In determining the amount of the money penalty assessed, the Commission is required to consider certain facts in addition to the gravity of the violation. In the case of a person whose primary business involves the use of the commodity futures market, the Commission is required to consider the appropriateness of such penalty to the size of the business of the person charged and the extent of such person's ability to continue in business. In the case of a person whose primary business does not involve the use of the commodity futures market, the Commission is required to consider the appropriateness of the penalty to the net worth of the person charged.

If a civil penalty is not paid, the Commission would refer the matter to the Attorney General, who would be required to recover the penalty by court action.

Civil penalties of not more than $100,000 are provided for each violation of orders to contract markets, directors, officers, agents, and employees thereof to cease and desist from violations of the Act, the rules, regulations, and orders thereunder. Such penalties would be collected by the Attorney General by court action, upon referral by the Commission. In determining the amount of such a money penalty assessed under section 6b, the Commission is required to consider the appropriateness of the penalty to the net worth of the offending person and the gravity of the offense, and in the case of a contract market, the Commission is required further to consider whether the amount of the penalty will materially impair the contract market's ability to carry on its operations and duties.

The fine for violating an order to cease and desist from violating the Act, rules, regulations, or orders thereunder, is increased from not less than $500 nor more than $10,000 to not more than $100,000.

The maximum fine for the criminal offenses provided in the three subsections of section 9 of the Act are increased from $10,000 to $100,000.

30. *Id.* §§ 9, 13a, 13b, 13(a), (b), (c).

Section 213.[31] *Authority of Commission to change contract market rules*

The Commission is given specific authority to alter or supplement the rules of a contract market insofar as necessary or appropriate by rule or regulation or by order. Before taking such action, the Commission is required first to make an appropriate request in writing to the contract market that it effect on its own behalf specified changes in its rules and practices.

The Commission could then alter or supplement such rules if, after appropriate notice and opportunity for hearing, the Commission determined that the contract market had not made the changes required and that such changes were necessary or appropriate for the protection of persons producing, handling, processing, or consuming any commodity traded for future delivery on the contract market, or the product or by-product thereof, or for the protection of traders or to ensure fair dealing in commodities traded for future delivery on the contract market.

The Commission could alter or supplement such rules with respect to such matters as: contract terms and conditions, the form and matter of execution of contracts; other trading requirements, excepting the setting of levels of margin (unless done pursuant to the emergency powers provided in section 215); safeguards with respect to the financial responsibility of members; the manner, method and place of soliciting business, including the content of such solicitations; and the form and manner of handling, recording, and accounting for customers' orders, transactions, and accounts.

Section 214.[32] *Rulemaking authority of Commission with respect to non-member registrants*

The Commission is authorized to issue rules and regulations with respect to registrants under the Act who are not members of a contract market, as in the judgment of the Commission are reasonably necessary to protect the public interest and promote just and equitable principles of trade, including but not limited to the manner, method and place of soliciting business, including the content of such solicitation.

Section 215.[33] *Emergency powers*

Specific authority is given to the Commission to direct any contract market, "whenever [the Commission] has reason to believe that an emergency exists, to take such action as, in the Commission's judgment, is necessary to maintain or restore orderly trading in, or liquidation of, any futures contract."

The term "emergency" is defined to mean "in addition to threatened or actual market manipulations and corners, any act of the United States or a

31. *Id.* § 12a(7).
32. *Id.* § 12a(8).
33. *Id.* § 12a(9).

foreign government affecting a commodity or any other major market disturbance which prevents the market from accurately reflecting the forces of supply and demand for such commodity."

Section 216.[34] *Disciplinary powers*

An exchange—or the Commission if the exchange fails to act—is authorized to suspend, expel or otherwise discipline an exchange member, or deny any person access to an exchange. Such action shall be taken solely in accordance with exchange rules.

Exchanges are required to notify the persons affected and the Commission of suspensions, expulsions, disciplinary actions, or denials of access, within 30 days, and give reason therefor, but otherwise to keep such notices and reasons confidential.

Review by the Commission of exchange disciplinary action is discretionary and, if allowed, in accordance with such standards and procedures as the Commission deems appropriate. Likewise, appeals to the Commission by persons who are disciplined is at the discretion of the Commission.

Section 217.[35] *Commission regulation of margin or leverage contracts*

The Commission is required to regulate transactions for the delivery of silver bullion, gold bullion, or bulk silver coins or bulk gold coins pursuant to a standardized contract commonly known as a margin account, margin contract, leverage account, or leverage contract.

All persons are prohibited from entering into or confirming the execution of any such transaction contrary to any rule, regulation, or order of the Commission designed to insure the financial solvency of the transaction or prevent manipulation or fraud. Notice and opportunity for hearing is required before such rule, regulation, or order is issued.

If the Commission determines that any such transaction is a contract for future delivery within the meaning of the Commodity Exchange Act, all of the requirements in the Act are applicable to trading in such transaction.

3. *TITLE III.—ENABLING AUTHORITY FOR CREATION OF NATIONAL FUTURES ASSOCIATIONS*[36]

The Commission is given authority to permit persons registered under the Act and in the commodity trading business to establish voluntary futures associations for regulating the practices of the members.

Persons eligible for membership in such an association include registrants under the Act, contract markets, and any other persons found eligible by the

34. *Id.* § 12c.
35. *Id.* § 15a.
36. *Id.* § 21.

Commission. Each applicant association is required to file with the Commission for review and approval a registration statement, in such form as the Commission prescribes, together with specified documentary materials. No applicant association is eligible for registration as a futures association unless the Commission finds, among other things, that such association is in the public interest and meets certain fitness standards and that its rules meet specified terms and conditions relating to such matters as membership, suspension, and expulsion of members, conduct of members and arbitration procedures.

The rules of the applicant association must, among other things, be designed to promote just and equitable principles of trade and "provide that its members and persons associated with its members shall be appropriately disciplined, by expulsion, susupension, fine, censure, or being suspended or barred from being associated with all members, or any other fitting penalty, for any violation of its rules."

The Commission is authorized to take such actions as: to revoke or suspend the registration of any futures association for failure to maintain its rules in conformity with the Act or other violation thereof; to set aside disciplinary action taken by a registered futures association against a member; to abrogate, alter, or suspend the rules of any registered futures association; to suspend or expel from a registered futures association any member or bar any person from being associated with a member if the Commission finds that such member or person violated the Act.

There are two stated inducements for belonging to a registered futures association. Each registrant not a member of such an association would (1) be required to pay such fees and charges as the Commission would establish "to defray the costs of additional regulatory duties required to be performed by the Commission because such person is not a member of a registered futures association," and (2) be subject not only to the obligations and requirements of the Act imposed on other persons but such other requirements and obligations as the Commission found necessary "to protect the public interest and promote just and equitable principles of trade."

The Commission's annual reports to the Congress must include information concerning the futures associations registered pursuant to Title III and the effectiveness of such associations in regulating the practices of the members.

4. *TITLE IV—MISCELLANEOUS PROVISIONS*

Section 401.[37] *Insider trading*

It is a felony punishable by a fine of not more than $10,000 or imprisonment for not more than five years or both, for any Commissioner of the Commission or any employee or agent thereof who, by virtue of his employment or position, acquires information which may affect or tend to affect the

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37. *Id.* §§ 13(d), (e).

price of any commodity futures or actual commodity and which information has not been made public, to impart such information with intent to assist another person, directly or indirectly, to participate in any commodity futures or option transaction or in any transaction in an actual commodity, or for another person to receive and use such information.

Section 402.[38] *Options trading*

The current ban now contained in section 4c of the Act on trading in options (privileges, indemnities, bids, offers, puts, calls, advanced guaranties, and decline guaranties) in Commodities Exchange Act regulated commodities is continued,[39] but trading in options in all other commodities if not done contrary to any rule, regulation, or order of the Commission prohibiting any such transaction, or allowing any such transaction under such terms and conditions as the Commission may prescribe, is permitted. The Commission may set different terms and conditions for different markets.

The one-year period for issuing regulations governing such options trading may be extended if the Commission determines and notifies the Senate Committee on Agriculture and Forestry and the House Committee on Agriculture, that it will be unable to promulgate such regulations within the one-year period.

Section 403.[40] *Arbitrage*

The Commission, in fixing trading and position limits, is authorized to exempt "arbitrage" transactions. "Arbitrage" in domestic markets is defined as the same as a "spread" or "straddle." The Commission is authorized to define the term "international arbitrage."

Section 404.[41] *Hedging*

The Commission is authorized to define "by order consistent with the purposes of this Act" the terms "bona fide hedging transactions or positions." The new definitions—which would, of course, be subject to subsequent amendment under the Commission's rulemaking authority—are to be issued within 90 days[42] after the effective date of the Commodity Futures Trading Commission Act of 1974.

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38. *Id.* § 6c.

39. Wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, Solanum tuberiosum (Irish potatoes), wool, wool tops, fats and oats (including lard, tallow, cottonseed oil, peanut oil, soybean meal, livestock, livestock products, and frozen concentrated orange juice.) 7 U.S.C. § 2 (1970).

40. 7 U.S.C. § 6a(1) (Supp. IV, 1974).

41. *Id.* § 6a(3).

42. An amendment delayed the date by which the new definitions are required to be made to 180 days. Act of April 16, 1975, Pub. L. No. 94-16, § 4, 89 Stat. 78, *amending* 7 U.S.C. § 6a(3) (1970) (codified at 7 U.S.C. §6a(3) (Supp. IV, 1974)).

However, immediately upon enactment, the Secretary of Agriculture must issue regulations defining bona fide hedging transactions and positions to allow hedging by users of products of traded commodities as well as hedging by seed companies of the contract bushel equivalent of anticipated seed production. Such regulations would, of course, only be applicable with respect to commodities regulated prior to the enactment of the 1974 Act.

Section 405.[43] *"Crossing of trades" authority*

A futures commission merchant or floor broker who has in hand, simultaneously, buying and selling orders at the market for different principals for a like quantity of a commodity for future delivery in the same month, is not prohibited by the Act from executing such buying and selling orders at the market price if such execution takes place on the floor of the exchange by open outcry and is duly reported, recorded, and cleared in the same manner as other orders executed on the exchange.

The Commission is specifically given rulemaking authority regarding the manner of the execution of such transactions.

Section 406.[44] *Authority to decide whether contracts must provide for delivery of commodities conforming to United States standards*

The delivery of commodities conforming to official United States standards is required if such standards are adopted by the Commission.

Section 407.[45] *Enforcement of contract market bylaws, rules, regulations, and resolutions*

Each contract market is required to enforce all bylaws, rules, regulations, and resolutions which relate to terms and conditions in contracts of sale to be executed on or subject to the rules of such contract market or relate to other trading requirements and which have been approved by the Commission. In addition, each contract market is required to revoke and not enforce any bylaw, rule, regulation, or resolution, which has been disapproved by the Commission.

Section 408.[46] *"Referee" changed to "Administrative Law Judge"*

Officials formerly called "referees" are now called "Administrative Law Judges."

Section 409.[47] *Criminal penalities extended to new offenses being added to the Act*

Criminal sanctions are provided for failure to register by commodity trading advisors, commodity pool operators, and persons associated with futures

43. 7 U.S.C. § 6b (Supp. IV, 1974).
44. *Id.* § 7a.
45. *Id.*
46. *Id.* § 9.
47. *Id.* § 13(c).

commission merchants or with any agents thereof, and for acts of fraud or deceit by commodity trading advisors and commodity pool operators.

Section *410.*[48] *Provision for supergrade positions*

The Commission is authorized to place an additional twenty positions in GS-16, GS-17, and GS-18 for purposes of carrying out its functions.

Section 411. Transfer of operations and proceedings to Commission

All operations of the Commodity Exchange Commission and of the Secretary of Agriculture under the Commodity Exchange Act, including all pending administrative proceedings, are transferred to the new Commission as of the effective date of the 1974 Act and continue to completion. All rules, regulations, and orders previously issued by the Commodity Exchange Commission and by the Secretary of Agriculture under the Commodity Exchange Act to the extent not inconsistent with the provisions of the 1974 Act continue in full force and effect unless and until terminated, modified, or suspended by the new Commission.

Section 412. Pending proceedings under existing law

Pending proceedings under existing law are not abated by reason of any provision of the 1974 Act, but shall be disposed of pursuant to the applicable provisions of the Commodity Exchange Act, as amended, in effect prior to the effective date of the 1974 Act.

Section 413. Separability

If any provision of the 1974 Act or the application thereof to any person or circumstances is held invalid, the validity of the remainder thereof and the application of such provision to other persons or circumstances shall not be affected thereby.

Section 414.[49] *Market reports*

The Commission is authorized to investigate markets for goods, articles, services, rights, and interests which are the subject of futures contracts, and publish regular market reports. The Commission is required to cooperate with other Federal agencies to avoid unnecessary duplication of information-gathering activities. Other agencies are required to furnish market information to the Commission, which would in turn be subject to any rules of confidentiality applying to the information.

Except as provided in section 8 of the Act, the Commission shall not disclose in the market reports data and information which would separately

48. 5 U.S.C. § 5108(c)(12) (Supp. IV, 1974).
49. 7 U.S.C. § 20 (Supp. IV, 1974).

disclose the business transactions of any person and trade secrets or names of customers.

Section 415.[50] *Daily trading reports*

Every clearinghouse and contract market is required to maintain daily trading records. The Commission is to determine the type of trading records and the type of frequency of trading reports to be required of clearinghouses and contract markets.

Exchanges are required to publish daily reports of the volume of trading on each type of contract. The Commission is authorized to require exchanges to include additional information in such daily reports.

Section 416.[51] *Research and information programs*

The Commission is required to establish and maintain research and information programs to investigate new technology and the feasibility of its use for improving, strengthening, facilitating or regulating futures trading; to assist in developing materials for educating producers, market users, and the general public about futures trading; and to carry out the general purposes of the Act. Annual reports of such programs are required.

Section 417. Commission to report on need for legislation insuring owners of commodity futures accounts

The Commission is required to submit to Congress, not later than June 30, 1976, a report on the need for legislation insuring owners of commodity futures accounts and persons handling or clearing trades against loss due to insolvency or financial failure of FCMs.

Section 418. Effective date

Except as otherwise provided in the Commodity Futures Trading Commission Act, the effective date of the Act is the 180th day after enactment, October 23, 1974.

The Commission is established on enactment, and activities necessary to implement the changes effected by the 1974 Act may be carried out after the date of enactment and before as well as after the effective date. Such activities may include—but are not limited to—the following: designation of boards of trade as contract markets, registration of futures commission merchants, floor brokers, and other persons required to be registered, approval or modification of bylaws, rules, regulations, and resolutions of contract markets, and issuance of regulations, effective on or after the 180th day after enactment; appointment

50. *Id.* § 6g.
51. *Id.* § 22.

and compensation of the members of the Commission; hiring and compensation of staff; and conducting of hearings and investigations.

Nothing in the 1974 Act limits the authority of the Secretary of Agriculture or the Commodity Exchange Commission prior to the 180th day after enactment.

Funds appropriated for the administration of the Commodity Exchange Act may be used to implement the 1974 Act immediately after the date of enactment.

III. Current and Future Federal Oversight

Although less than one year has elapsed since passage of the Commodity Futures Trading Commission Act of 1974, progress in implementing the needed reforms has been substantial. Although there was a delay of over six months by the President in nominating the Members of the Commission, all of the members have now taken office and are engaged in the task of carrying out their new statutory duties.[52]

I believe that the Commission's accomplishments should be emphasized, accomplishments such as authorizing the continued operation of contract markets which previously traded in non-regulated commodities; investigating and registering thousands of commodity trading advisors, commodity pool operators, futures commission merchants, and their associates, both domestic and foreign; and extending the reporting requirements to trades in previously non-regulated commodities such as cotton, petroleum, metals and some 29 others.

However, enactment of this Act does not mean that additional federal legislation is not needed. On the contrary, there are a number of related areas which clearly need additional study and investigation to determine whether additional legislation would be appropriate and desirable.

A. *Trading by Computer*

The current and historic system of trading in the pits of commodity exchanges is no longer the only way to match customers' buying and selling orders.

For example, there could be a new system whereby trades are matched electronically by computer and orders could be filled directly through exchange-operated computers.

One of the principal benefits of developing such a computer system to match buying orders with selling orders would be the avoidance of the circumstances in which there are possibilities of abuses and the creation of an atmosphere whereby public confidence in futures trading could be restored.

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52. Commission members include William T. Bagley, Chairman, Gary L. Seevers, John Rainbolt, Read P. Quinn, Jr., and Robert Martin.

Use of a computer might also lend a degree of stability to the futures markets by eliminating market emotionalism and hysteria which are too often present today. Some scalpers pay no attention whatever to supply and demand, government reports, and so forth, but instead attempt to detect the feeling that other speculators have as to the change in the market. If a belief in the pit on the part of most of the traders that the market will go up is detected, some traders believe the market is bound to go up for at least a short period of time despite the lack of any rational reason. Under those circumstances, some sclapers buy and help to feed the belief the market will go up. These scalpers then get out the second the run slows down or before the market reverses itself, which may be only a few minutes later. One such scalper admitted that he almost never holds any contracts overnight and usually he holds them for only a small portion of the day.

One witness was particularly critical of the role played by these scalpers, that is day market traders. He expressed the opinion that the professional traders (scalpers) steal from the market. He said they can do it all day and added: "These fellows make a lot of money." Using a computer, he concluded, "would be a way of eliminating a lot of problems in trading."

There can be no question but that it would be beneficial to the whole process if some of the turmoil and emotionalism in the pit could be avoided. In addition, many futures customers would also feel more certain that they are getting the best price available if they or their agent, far removed from the pit, could place the order by electronic device and see it matched the same way. In effect, a trader would bid by computer until his bid is accepted. For these and other reasons, every encouragement should be given to the development of such a mechanical trading system. Following the Subcommittee hearings, a study of computers for this purpose was funded and positive proposals for the consideration of the new commission and the Boards of Trade will be forthcoming.

B. *Insurance Corporations*

Some protection is afforded to commodities futures investors because of certain operating restrictions placed upon futures commodities markets by the Act. This protection does not, however, guard against theft, embezzlement, or insolvency of the FCM. At the present time, the commodities futures investor must assume the risk of such a loss.

In the course of the hearings, numerous witnesses expressed concern about the possibility of such losses occurring. Although no examples of such losses being incurred by futures customers in regulated commodities were presented to the Subcommittee, the witnesses felt that the danger was present. It should also be noted that the concern over losses is magnified because of the closely intertwined nature of the industry as if one firm goes, it could easily have a domino effect and topple other firms which were doing business with it. In 1971 a bill was introduced in the Senate to create a Federal Commodity Account Insurance Corporation to provide commodity customers financial guarantees similar to those the Securities Investor Protection Act gives security customers. The bill would have reduced the risk of loss to customers when a broker in commodity futures contracts becomes unable, due to financial reverses or failure, to pay amounts owed to its customers, or to other brokers representing customers, or to the clearing organizations of the commodity exchanges. Since many of these same firms are brokers in commodity futures contracts as well, the bill would have augmented the Securities Investor Protection Act by protecting all customers who could sustain losses from the failure of a firm.

It appears that some form of protection is necessary as the bankruptcy or insolvency of a futures commission merchant, while an infrequent occurrence, can place in jeopardy large sums of money held for customers by that firm and any such losses could lead to a serious loss of public confidence and subsequent further deterioration of the future markets.

C. *Grain Reserve Policy*

I believe the United States should implement a national policy designed to insure sufficient reserves of wheat, feed grains, and soybeans which should be expressed in terms of a fixed percentage of total annual consumption of each of these commodities.

Manipulation and squeezes in the commodity markets occur when there is a shortage of a particular commodity. During a period of short supply, a big operator or some big operators can create a greater shortage by withholding a relatively small supply from a deficit market which would pay higher prices. Cornering futures obligations in advance is one way of compelling someone to pay a higher price than they had expected to pay. Monitoring the futures markets by a commission is designed to help prevent excesses and greater distortions by enforcing limits on speculation, reporting traders positions, and by detecting and penalizing those who abuse the rules. However, the basic factor permitting the manipulation or squeeze is still the shortage of product in the deficit market. Although transportation and other factors may add to the problem, the main problem is erratic supplies.

The reserve supply must be fed into the market only in periods of severe shortage and in volumes previously agreed upon so the farmer can know the amount of supplies available and continue to adjust production levels based on price; however, until and unless we have sufficient reserves of basic commodities which can be marketed when supplies are low, the problem will continue to be more persistent than necessary.

The events of 1973 demonstrated the potential impact on food and feed supplies and prices of a serious downturn in one year's production in the face of continually mounting world demand. This followed, by only one year, a market so low that U. S. producers were selling for less than the cost of production, which remains relatively stable or constantly increases. The magnitude of today's changes in supply and demand for grains will make it increasingly difficult for our market to absorb the increases in demand out a single year's production, and may result in periodic, serious domestic shortages of some commodities and periodic bankrupt conditions for producers.

At the same time, the United States has assumed the role of being a major supplier of the world's basic foods. This is both an opportunity and an obligation. As the world storekeeper we must have sufficient supplies at reasonably stable prices. This expanded world trade in agricultural products has made farmers more dependent upon satisfied foreign consumers and our Nation more dependent upon the sale of such products to prevent deficits in our balance of payments.

In 1972, there were widespread crop shortfalls abroad, but the United States was in the fortunate position of having reasonably adequate carryover supplies of wheat and feed grains to sell. On the other hand, the collapse of Peruvian fishmeal supplies caught us without adequate carryover stocks of soybeans with which to meet the surge in demand for protein meal that resulted. The contrast between these two experiences—even though the surge in wheat demand was staggering—offers a telling lesson. Suggested grain reserves proposals would provide the tools needed to carry over surpluses the next time they accumulate to a subsequent year when they are needed, while reducing wide fluctuations in prices would also assure that our regular customers will have a sufficient supply; otherwise, we will not be a dependable supplier, we will lose customers, and our commodity markets will be more susceptible to manipulation.

A grain reserve program would allow our trading partners to expect that they could depend upon us for supplies of food and feed grains and they could then avoid the necessity of diverting their resources into artificial stabilization of agricultural production which would compete with our exports. Thus, the reserves would help to build markets by demonstrating that supplies are available to meet expanded market demand.

D. *Russian Grain Sales—Foreign Speculation*

In July and August, 1972, sales of wheat to Russia were made totaling about 440 million bushels for a total of about $700 million. Those sales of wheat accounted for approximatetly 50 percent of the record 1.1 billion bushels of wheat export sales in fiscal year 1973. In addition, the 1972 grain sales to Russia included barley, corn, sorghum, and soybeans, so that in all, about 725 million bushels of grain were sold to Russia. The agreements provided a minimum to be purchased by Russia over a 3-year period, but did not limit the amount they could take in one year. It now appears that they signed contracts for about 50% or more than they actually needed.

The amount to be moved was far more than expected by the industry and was to be moved on short notice. Movement of this grain to gulf ports for export greatly compounded the problem of movement of grains harvested in the fall of 1972. The magnitude of the wheat sales, the shortage of transportation to move that volume, and a sharp increase in other demand, all exerted an upward pressure on prices.

There still exists a very real and great danger that futures markets can be as much or even more distorted and manipulated by foreign companies because some have access to the huge resources and financial backing of foreign governments. The earlier discussion in this regard is also pertinent here. If a big grain trading company sells to a foreign government, that company can hedge on the commodity markets by buying contracts on the long side. The company's reports to the Commission would show the transaction as a hedge, but it might not be known for 2 weeks or longer who contracted for the grain. Even then, the records would not show whether the foreign customer is really using the purchase for speculation or whether it is for consumption. By dealing with four or five big companies simultaneously, the way the Russians did, a foreign company or a foreign country could buy at a fixed price almost an entire wheat crop. Foreign interests could have purchased more than they did in 1972-73 and the grain companies who sold to them would not know at the time they signed their contracts at a fixed price the extent to which other companies were obligating themselves on fixed-price contracts. Indeed, this happened in the Russian grain deal and representatives of Cargill (one of the major companies involved in this sale) admitted before the Subcommittee that although they assumed the Russians were negotiating with others, Cargill had no idea that the Russians were buying the quantity of wheat which they did.

Because of the extent of the wheat sales to Russia and because delivery was to be delayed, it was expected that the grain companies involved would move into both the cash market and the futures market to protect their commitments. According to a report by the General Accounting Office which conducted a study of this grain sale, the other five major companies involved in the wheat sales were Cook, Bunge, Dreyfus, Continental, and Garnac.

Data obtained from the CEA showed that these grain companies quickly moved into both the cash and the futures market which made it appear that the demand for wheat had increased tremendously and a boom market was underway. Under the reporting practices, even with the provisions in the 1973 agricultural bill, it may be as long as two or three weeks before the extent of sales is known and an opportunity is had to compare those sales against probable needs of that country or foreign companies. This is enough time to wreak havoc upon the commodity markets and let these giant companies profit at the expense of the small businessman and the consumer who are unaware of the sales.

If the foreign companies want to, they could hold and demand delivery of the entire purchase at the fixed price or they could wait until a later date and dump part of it. One can easily see how they could take delivery of as little as one-fourth of a big purchase and secure enough profit from the resale of the rest to pay for the grain they receive.

When it is so easy for foreign customers with huge resources to do this and when large export companies under certain circumstances can legally share in the gain by double hedging in excess of the usual limits, it is inevitable that a huge manipulation or distortion in a commodity will occur if steps are not taken to prevent it.

When this happens, there will be a strong demand to abolish commodity markets and impose export controls. Export controls would be dealing with a situation after the damage had mostly been done and in a very bad way. The better way is to prevent such a situation from happening.

If companies which use the commodity markets were required to report export sales they have made and expect to hedge on the commodity markets within 24 or even 48 hours of the sale, then in the event a foreign company or country is setting up a manipulation or squeeze, the surveillance agency could move rapidly enough to protect against such severe damages. Government officials could compare total sales made to a particular company or country or to a company buying for a particular country's use with official estimates for demand in that country. If it appeared that the purchases were far in excess of demand, then the appropriate Government officials could inquire and determine if the estimates were in line. If it appeared they were in fact moving into a position to manipulate the market with the help of a fixed-price purchase which private grain companies would not give them but for the fact that they were able to hedge the sale on the commodity markets, the hedging of further sales to that country could be stopped or other action taken to prevent shifting the cost of such a squeeze onto the U. S. industries affected.

This provision, requiring quick reporting of fixed-price sales, would somewhat equalize the position of those involved in commodities; it would not prevent any foreign country or foreign company from buying commodities for delivery at a flexible price and the net effect would be to cause big companies selling to those countries to sell the additional quantities in excess of need on a flexible-price basis rather than on a fixed-price basis. That would eliminate the possibility of foreign purchasers making huge profits at the expense of domestic interests as it would negate the reason for huge overbuying or overselling. Preventing these big foreign customers from buying far more than their needs at a fixed price and then paying for their actual needs by profits earned on our markets, would be far preferable to export controls and would not disrupt the whole market mechanism the way export controls would.

Prohibiting the hedging of excessive foreign sales is not the only answer; it merely serves to point out the tremendous risk which exists today that the commodity markets could be manipulated indirectly by foreign companies with huge resources available and it also points out that a contingency plan should be developed and ready for use on any day when this occurs.

In order to put any contingency plan into effect, it is necessary to know within a matter of two or three days rather than two or three weeks, as is the case under existing law, the identity of the country and the size of the sales.

Legislation which I have introduced, H.R. 3281,[53] would provide for timely sales reports from international exporters and for immediate dissemination of this information to the public. While Secretary of Agriculture Butz opposed my bill providing such reporting requirements, he has sometimes announced voluntary reporting on a 24 hour basis. I think the requirement should be constant and compulsory.

It also appears clear that a Federal agency needs some specialists who are constantly looking for possible ways that the market can be manipulated and then developing plans to deal with such cases in the same way the Defense Department constantly anticipates all possible actions against our best interests and develops contingency plans to deal with them.

E. *Dissemination of Information, Including Export Sales*

The Russian grain deal also points out the necessity of improving the reporting system on exports. The present program for mandatory reporting of export sales commitments contains too many weaknesses. For example, there are too many "unknown destinations" on export sales commitment reports. Grain could be bought by buyers in Europe or elsewhere who have not in turn sold it as yet. There should be a requirement identifying the buyer or a requirement identifying the destination, or preferably there should be both.

It is apparent that knowledge of the destination of the grain to be exported is important in terms of the interest of the government in determining its political and long-term economic relations with other countries. Destination is important also in calculating how much of the anticipated demand a certain country will have, and how much has been filled.

There is also a need for additional dissemination of data regarding day-to-day positions of large traders. Large grain merchandisers make daily reports on their hedged positions on the futures markets and weekly reports of all their cash positions. However, the overall compilation in a monthly report usually is not issued until the middle of the following month. There is a need for a more rapid method of dissemination of the compiled information of total positions, and information concerning those trading.

If we again look back at our experience of the past few years, it should be clear that any information secured by the Department of Agriculture relative to world grain production and consumption should be made immediately and accurately available. Failure to do so gives an unfair advantage to big grain exporters and through them to the purchasers of this grain at the expense of producers in this country.

IV. Conclusion

I believe that the legislation enacted last year as the Commodity Futures Trading Commission Act of 1974 is a significant milestone. Futures trading is

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53. *See* appendix II, *infra.*

an extremely complicated subject about which very few are knowledgeable, including those who venture into it. I had hoped that Congress would enact legislation which would have afforded even greater protection to both futures traders and to those who are in agriculturally related industries whose operations are so closely intertwined with such trading. Even though this was not possible, nonetheless I am very pleased with what was accomplished as a revitalized agency has been created to oversee futures trading and I am confident that under its auspices those involved in the production, processing, and marketing of commodities can be afforded a marketplace where they can protect themselves against rapid fluctuations of commodity prices.

APPENDIX I

DEFINITION OF TERMS AND MECHANICS OF FUTURES TRADING

DEFINITION OF TERMS

Basis.—The difference between the price of the cash commodity and the price of a designated futures contract for that commodity.

Board of trade.—An exchange or association, whether incorporated or unincorporated, of persons engaged in the business of buying or selling any commodity or receiving the same for sale on consignment.

Cash commodity.—The physical or actual commodity as distinguished from the "futures."

Clearing member.—A person who is a member of, or who enjoys the privilege of clearing trades in his own name through, the clearing organization of a contract market.

Contract market.—A board of trade designated as a contract market under the Commodity Exchange Act.

Delivery.—The tender and receipt of the actual (cash) commodity, or of warehouse receipts covering such commodity, in settlement of a futures contract.

Delivery month.—The specified month within which a futures contract matures and can be settled by delivery.

Floor broker.—Any person who, in or surrounding any pit, ring, post, or other place provided by a contract market for the meeting of persons similarly engaged, shall purchase or sell for any other person any commodity for future delivery on, or subject to the rules of, any contract market.

Floor trader.—A member of a contract market who, on the exchange floor, executes a futures trade for his own account or an account controlled by him, or has such a trade made for him.

Futures contract.—An agreement to buy and receive, or to sell and deliver, a commodity at a future date in accord with standardized terms.

Futures commission merchant.—Individuals, associations, partnerships, corporations, and trusts engaged in soliciting or in accepting orders for the purchase or sale of any commodity for future delivery on, or subject to the rules of, any contract market and that, in or in connection with such solicitation or acceptance of orders, accepts any money, securities, or property (or extends credit in lieu thereof) to margin, guarantee, or secure any trades or contracts that result or may result therefrom.

Hedge.—The sale of futures against the purchase of the cash commodity or its equivalent as protection against a price decline; or the purchase of futures against forward sales or anticipated requirements of the physical commodity as protection against a price advance.

Long.—The buying side of an open futures contract. A long position is subject to receipt of the cash commodity if it is not offset with a sale of a futures contract.

Offset.—Usually, the liquidation of a long or short futures position by an equal and opposite futures transaction. Open positions can be offset at any time during the life of a futures contract.

Open contracts, open interest.—The obligation entered into by a party to a futures contract either to buy or to sell the commodity specified. The obligation is "open" until it is settled by an offsetting transaction or by delivery.

Scalper.—A speculator who trades for himself in the pit and is in and out of the market on very small price fluctuations, ordinarily closing the day with few or no open contracts.

Short.—The selling side of an open futures contract. A short position is subject to making delivery of the cash commodity if it is not offset with the purchase of a futures contract.

Speculator.—A person entering into futures contracts for any purpose other than hedging.

Spread.—The purchase of one futures contract against the sale of another contract in a different future, a different commodity, or a different market or the price difference between two futures in the same or different markets.

THE MECHANICS OF FUTURES TRADING

Placing orders.—The customer contacts a solicitor or account executive who in turn transmits the order, either directly or through a central office, to the exchange trading floor. The order is received on the trading floor by the firm's phone man. After recording and time-stamping the order, he gives it to a runner who carries the order to a floor broker in the designated trading area for that commodity. These trading areas are called pits or rings and each delivery month of a commodity is generally traded in a certain area of the pit or ring. Some firms no longer telephone orders to the floor. Instead, the orders are fed through a computerized system that transmits them to the floor via teletype.

Execution of trades.—The actual trading of futures contracts takes place in the noisy, boisterous setting of an auction-type market. The Commodity Exchange Act requires that all futures transactions in regulated commodities be executed on a commodity exchange designated as a "contract market." Both the Commodity Exchange Act and the rules and regulations of the commodity exchanges require that futures transactions be executed openly in a competitive manner. Section 1.38 of the regulations under the Commodity Exchange Act reads as follows:

> All purchases and sales of any commodity for future delivery on or subject to the rules of a contract market shall be executed openly and competitively by open outcry or posting of bids and offers or by other equally open and competitive methods, in the trading pit or ring or similar place provided by the contract market, during the regular hours prescribed by the contract market for the trading in such commodity.

Certain carefully prescribed exceptions to competitive trading are allowed, but they do not nullify the general requirement of open and competitive trading.

The purpose of this requirement is to insure that all trades are executed at competitive prices and that all trades are focused into the centralized marketplace to participate in the competitive determination of the price of future contracts. This system also provides ready access to the market for all orders and results in a continuous flow of price information to the public.

The rules requiring competitive trading also require that all trades be executed in the area and during the hours designated by the contract market. Thus, each exchange has a monopoly on the trading of its own contracts. Other exchanges can trade virtually identical contracts for the same commodity, provided they meet the requirements of a contract market as specified by the Commodity Exchange Act and are so designated.

Clearing trades.—After a trade has been executed, the confirmation of the trade retraces the path of the initial order within a few minutes. Final confirmation, however, cannot be made until the trade goes through the clearinghouse. In the clearinghouse, both sides of the trade must be matched, and any differences between the buyer and seller must be referred to the clearing firms involved for reconciliation.

A brief description of the clearing procedure for futures trading points out one of the major distinctions between futures and securities trading. Unlike securities, there is no certificate or document exchanged in a futures transaction. The futures contract is embodied in the rules and regulations of the contract market.

The clearinghouse (or clearing association) performs the functions of matching all buys and sells which are executed each day and of assuring the financial integrity of all futures transactions. As trades are matched and confirmed at the end of each trading session, the clearinghouse takes the opposite side of every transaction. It becomes the seller of all buys and the buyer of all sells. Thus, when a trader establishes a position in the market, he does so with the clearinghouse, and when he offsets his position he offsets it with the clearinghouse. The clearinghouse assumes the legal responsibility for the opposite side of every transaction made on the contract market.

The clearinghouse requires that its members deposit margins to secure their firm's futures transactions. The clearing members, in turn, require margins from their customers. If the market moves against the open contracts of a clearing firm, that firm's initial margin is impaired and additional margin will be required.

Daily payments or receipts also occur between the clearinghouse and its members to account for daily price changes. The clearinghouse maintains the open accounts of member firms at the current market prices. At the end of each day, these accounts are adjusted to the day's settlement price for each contract. Firms with net gains receive payment from the clearinghouse, while firms with net losses make payments to the clearinghouse. These receipts and payments of the clearinghouse exactly offset one another, with the clearinghouse merely transferring equity from losers to winners.

Deliveries.—Deliveries on futures contracts are also made through the clearinghouse. A seller wishing to make delivery on a futures contract during the delivery month files a delivery notice with the clearinghouse on the day prior to the intended delivery. The clearinghouse then assigns the notice to the clearing member having the oldest long position in that particular future. At this point, the clearinghouse has completed its role, and the delivery must be consummated between the buyer and seller in accordance with exchange rules.

Appendix II

94th CONGRESS
1st Session

H.R. 3281

IN THE HOUSE OF REPRESENTATIVES

February 19, 1975

Mr. Smith of Iowa introduced the following bill; which was referred to the Committee on Agriculture

A BILL

To amend the Commodity Exchange Act to require public disclosure of certain information relating to sales of commodities for export, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That the Commodity Exchange Act, as amended, is further amended by inserting after section 8c the following:

"Sec. 8d. The Commission shall revoke the registration of any futures commission merchant, associate of any futures commission merchant, commodity pool operator or floor broker—

"(1) who accepts or places, either directly or indirectly, any order for the purchase or sale of any commodity for future delivery on any contract market from any person who has been found in violation of the provisions of section 19; or

"(2) who, himself, is a person who has been found in violation of the provisions of section 19.

Any such person whose registration is revoked in accordance with this section shall not be eligible to reapply for registration until twelve months after the date of revocation."

Sec. 2. The Commodity Exchange Act, as amended, is further amended by adding at the end thereof the following new section:

"Sec. 19. Any person who sells any commodity (as defined in section 2 of this Act) for export shall, within forty-eight hours after such sale, inform the Commission of (1) the date of such sale, (2) the name and full identity of the commodity sold, (3) the quantity of the commodity sold, (4) the name of the buyer and the country or countries to which the commodity is to be shipped, (5) the sale price, and (6) such other information as the Commission may by regulation require. The Commission shall by regulation prescribe the manner in which the above information shall be transmitted. On the first working day following its receipt, such information shall be made available by public announcement and shall remain available for public inspection for a reasonable time thereafter. The Commission shall prescribe regulations to assure that such information shall be disclosed simultaneously to the public and to protect against any person or firm gaining from premature disclosure."

Sec. 3. The amendments made by this Act shall become effective thirty days after enactment.